

8-2013

Governance of Financial Reporting

Poh Sun SEOW

Singapore Management University, psseow@smu.edu.sg

Gary PAN

Singapore Management University, garypan@smu.edu.sg

Follow this and additional works at: https://ink.library.smu.edu.sg/soa_research

Part of the [Accounting Commons](#), and the [Business Law, Public Responsibility, and Ethics Commons](#)

Citation

Pan, Gary and Seow Poh-Sun. 2013. "Governance of Financial Reporting". *Getting your Accounting Right*, edited by Themis Suwardy and Wang Jiwei, 53-62. Singapore: SMU and CPA Australia.

This Book Chapter is brought to you for free and open access by the School of Accountancy at Institutional Knowledge at Singapore Management University. It has been accepted for inclusion in Research Collection School Of Accountancy by an authorized administrator of Institutional Knowledge at Singapore Management University. For more information, please email libIR@smu.edu.sg.

Getting your accounting right

Edited by Themis Suwardy and Wang Jiwei



Getting your accounting right

Themín Suwardy & Wang Jiwei

Editors

Table of Contents

First published August 2013

Copyright ©2013 CPA Australia

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the publisher, except for inclusion of brief quotations in a review.

The views expressed in this publication are those of the respective authors and do not necessarily represent the views of, and should not be attributed to, CPA Australia Ltd or Singapore Management University School of Accountancy.

Getting your accounting right

Editors : Themis Suwardy & Wang Jiwei
Published by : CPA Australia Ltd
1 Raffles Place
#31-01 One Raffles Place
Singapore 048616
Website : cpaustralia.com.au
Email : sg@cpaustralia.com.au
ISBN : 978-981-07-6664-1

Foreword	iv
Preface	vi
Prologue	viii

Part 1	Getting it right	
Chapter 1	An Ecosystem for Achieving High Quality Financial Information	3
Chapter 2	Understanding Financial Reports	21
Chapter 3	Financial Reporting: Myths and Realities	39
Chapter 4	Governance of Financial Reporting	53
Chapter 5	Understanding Audit and Assurance	63
Chapter 6	The Financial Close – Adding Value to Your Business	77
Chapter 7	Preparing High Quality XBRL Financial Statements	91
Chapter 8	A Simpler Standard for Small Entities	103

Part 2	Technical updates	
Chapter 9	Fair Value Measurement	117
Chapter 10	Consolidation Suite of New Standards	139
Chapter 11	The New Wave to Financial Instruments – IFRS 9	161
Chapter 12	Annual Improvements Project and Revenue	181

Foreword by ACRA

Companies need a strong core in today's changeable economy so they can withstand change and adapt without losing strength or momentum.

Strong financial reporting is a key part of a company's strength. The ability to trust and understand a company's financial position is essential for businesses and their investors. When economic winds change and business challenges and opportunities arise, timely and accurate financial information is your most important tool.

On the other hand, erroneous or out of date financial reports leave a company exposed to losses and lost opportunity. The results can be devastating for businesses and their investors and creditors.

It is therefore important for any company to invest in its financial reporting process and spend the time to make it work efficiently and in tune with the whole business. With the right help, this need not be difficult.

This book, "Getting Your Accounting Right" is a welcome initiative to help everybody in the financial reporting ecosystem. Management and shareholders can have a better understanding of the role, governance and audit of financial statements. Preparers can be updated on the major changes in accounting standards that would impact the preparation and filing of financial statements. All parties can tap on various tips to help them address challenges in financial reporting.

This book is a commendable effort from the accounting profession, spearheaded by CPA Australia and Singapore Management University's School of Accountancy, with contributions from practitioners, academics and regulators.

Working together in this way helps us to uphold confidence even amidst economic uncertainty. Market trust in the accuracy, reliability and integrity of financial information of all companies is critical. I urge all businesses owners and management as well as finance and accounting staff to take the time to read this guide and enhance the quality of financial reporting in their companies.

Kenneth Yap
Chief Executive
Accounting and Corporate Regulatory Authority (ACRA)

August 2013

Preface by CPA Australia and SMU School of Accountancy

Financial reporting plays a central role in global economies and business. Investors and providers of capital require information about companies' financial health in order to make informed decisions on where to park their money.

In recent years, the debate has shifted from just routine financial reporting to an emphasis on **quality** financial reporting. The International Financial Reporting Standards (IFRS) framework, developed and maintained by the International Accounting Standards Board (IASB), seeks to help in one respect. The IASB aims to “develop a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles”.

Keeping pace and understanding the constant evolution of IFRS has been a challenge to many in the financial reporting ecosystem. Auditors have had the benefit of training either in-house or through their professional bodies on the many changes in accounting standards. Preparers of financial statements, on the other hand, sometimes struggle.

As educators, CPA Australia and the Singapore Management University School of Accountancy are pleased to be part of the effort to enhance the competencies of preparers on getting their accounting right. Financial reporting is a shared responsibility of many parties in the accounting ecosystem. We believe other stakeholders would also find this book a meaningful and useful step in this direction.

We thank Associate Professors Themis Suwardy and Wang Jiwei, the book's editors, ACRA and our partners in the professional services firms for their support and contributions to this publication. We trust you will find the information presented in the various chapters valuable in your professional roles.

Melvin Yong
General Manager – Singapore
CPA Australia

Professor Pang Yang Hoong
Dean, School of Accountancy
Singapore Management University

August 2013

Prologue

Financial reporting is pivotal in communicating with investors, creditors, regulators, employees and many other stakeholders of modern businesses. The quality of financial reporting depends not only on audit and assurance practitioners but also on the preparation process of financial reporting. To have high quality financial reporting, we should help directors and preparers get it right from the start.

We bring together authors from practitioners and academia to contribute articles on the topic of “Getting your accounting right”. The objective is to help business directors and accounts preparers to understand the importance of high quality financial reporting to their business and get it right from the start. High quality financial reporting is a process, not a fixed destination. It is a journey that begins with a better understanding of the various stakeholders in the ecosystem, the key elements in ecosystem and getting a grip on the continuing changes in financial reporting standards that will lead to a more relevant and faithful representation of economic phenomenon of a business.

We do not have all the answers in this book, but we have put together articles that would hopefully point readers to the right directions and provide references for further reading. In Part 1, we start by presenting an ecosystem for achieving high quality financial information, followed by some guides to preparing financial reports. We have included in Part 2 important technical updates of major accounting standards that would shape financial reporting in the coming years.

This book is organised as follows:

The first part (Chapters 1-8) provides guides to preparing high quality financial reports. **Chapter 1** explores an ecosystem for achieving high quality financial information. In this chapter, the authors describe the needs of high quality financial information and its importance to all businesses. The authors have included various views from the top, from leaders in the accounting profession to business leaders, regulators and other parties, on the benefits of high quality financial information.

All business owners and investors need to understand financial reports. Such an understanding will help to speed up the dissemination of information, reduce information asymmetry and lower a company’s cost to access capital. Thus, **Chapter 2** will help readers understand the four primary financial statements and suggest a simple approach to reading financial reports. This chapter is especially important to investors and managers who may not have enough prior accounting knowledge.

Chapter 3 explains some myths about financial reporting and accounting standards. It is the duty of directors to ensure financial statements are prepared, audited and filed properly, but some do so grudgingly, looking for the cheapest, fastest, easiest way to prepare, audit and file their financial statements. This chapter discusses three claims about financial reporting: (1) “management do not use financial statements”, (2) “financial statements do not matter”, and (3) “financial statements are just too complex”.

In **Chapter 4**, the authors present an overview of governance regulatory framework for financial reporting in Singapore, including Companies Act, Code of Corporate Governance and Singapore Exchange’s Listing Manual. The chapter also presents a portfolio of internal controls over financial reporting and a check list for internal control maturity.

Chapters 5-7 explore three important processes of financial reporting: closing the accounts, auditing the accounts and filing the accounts. In **Chapter 5**, the authors discuss why audit and assurance are needed and what exactly external auditors do when auditing accounts. Auditing and assurance play an essential role in the effective operation of our capital markets and the economy at large, providing confidence to current and prospective shareholders about the information disclosed by companies.

The financial close is an important element in the preparation of financial statements. **Chapter 6** shows how companies can improve their closing process. It starts by identifying the value that an effective close can bring. Companies should ensure that their financial close processes work efficiently and effectively. They need to develop (and implement) a concrete plan to monitor and reduce inefficiencies in their close process.

Chapter 7 presents an overview on how to prepare high quality XBRL financial statements, including some common errors observed by ACRA. Investors increasingly expect quick and convenient access to information and expect the information to be of a high standard - up to date, complete and accurate. Companies can meet these new expectations by filing high quality XBRL financial statements with ACRA.

If you are a director of small entity, you may opt to use a simplified accounting standard – *SFRS for Small Entities*. **Chapter 8** explains why the simplified accounting standard is beneficial to small and medium-sized companies and presents the major differences from the full SFRS. The major takeaway is that adopting *SFRS for Small Entities* will significantly reduce compliance costs and cost to access capital for your small business.

In the second part of this book (Chapters 9-12), we summarise some major technical updates on a number of critical accounting standards. They include fair value measurement (**Chapter 9**), consolidation (**Chapter 10**), financial instruments (**Chapter 11**) and revenue accounting and annual improvements project of IASB (**Chapter 12**). We trust these four chapters cover the most important and controversial changes in the recent development of accounting standards by IASB.

We are pleased to be a small part of this collaboration between ACRA, CPA Australia and SMU's School of Accountancy. We thank all other parties involved in the production of this book – the contributing authors, interviewees, and staff at CPA Australia Singapore office for their support in this project. We hope you, the readers, find this collection of articles thought-provoking and useful in your preparation of high quality financial reports.

Themis Suwardy and Wang Jiwei
Singapore Management University

Part 1

Getting it right

Chapter 1

An Ecosystem for Achieving High Quality Financial Information

Themis Suwardy, Singapore Management University

Melvin Yong, CPA Australia

“In an economic climate of uncertainty sometimes bordering on mistrust and paranoia, it is critical that as preparers, auditors or regulator, we work together to ensure that reliable and trusted financial information is made easily available to market users, who can sleep well at night knowing that their business decisions are supported by trusted data.”

Mr. Kenneth Yap, Chief Executive, ACRA
At CPA Australia's Financial Reporting Standards Forum,
May 2013

Introduction

In today's increasingly sophisticated business world, companies constantly face ever more complex operating conditions. How the financial health of companies is perceived among investors and capital markets is important in determining whether external stakeholders are comfortable with investing money with these firms.

Having accurate and reliable financial information is a crucial part of this puzzle. Financial reporting provides users with information to formulate corporate strategies, business plans and leadership initiatives. This is why it is important to strengthen the financial reporting function of companies by having good people, processes and tools across the whole value chain or ecosystem.

But the journey towards high quality financial reporting is not just a management responsibility. It requires all stakeholders to play their part, be they senior management, boards of directors, shareholders, investors, professional bodies or regulators. They all have a role in the financial reporting ecosystem.

What makes up high quality financial information and why should anyone care?

Quality is seldom reflected by a single dimension. David Garvin suggested that a product's quality can be assessed in eight dimensions: performance, features, reliability, conformance, durability, serviceability, aesthetics, and perception. What about something more abstract like the quality of financial reporting and financial information?

The *Conceptual Framework for Financial Reporting* states that the objective of financial reporting is to provide financial information about the reporting entity that is **useful** to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit. To be useful, financial information must have certain qualities or characteristics. Financial information that is **relevant** (i.e. capable of influencing a particular economic decision) and **faithfully represents** (i.e. complete, neutral and free from error) the underlying economic phenomenon would make financial information useful. Usefulness can be further increased by enhancing comparability, verifiability,

timeliness and understandability. Thus, we can surmise that higher quality financial information would better help users of financial statements in making financial decisions.

“Financial reports represent the financial position and financial performance of a company. They should therefore embody the core qualities of accuracy, consistency in application of accounting policies and compliance with accounting standards. Information presented should also be relevant and meaningful to its users, and reliable,” says Chng Lay Chew, CFO, Singapore Exchange.

But it is not just about populating a bunch of numbers on complicated spreadsheets that few people other than those who have spent countless hours preparing them would understand.

“Financial reports need to be presented in a format that is relevant, meaningful and comprehensible to all directors. They should highlight key business risks and paint an accurate picture of the management stewardship present in the company,” argues Lee Suet Fern, Senior Director, Stamford Law Corporation.

Sanjeev Agrawal, CFO (Singapore & Southeast Asia), Standard Chartered Bank, believes that financial reporting is one powerful tool which permits an organisation to connect to the market. High quality of financial reporting provides transparency to shareholders and other stakeholders in understanding the organisation's performance, its strength and how the organisation is poised for future growth.

“The transparency through a high quality of financial information results in building confidence of the organisation's shareholders and regulators. This could result in positively influencing share prices, capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions enhancing overall market efficiency. High quality of the financial reporting provides an edge over the competition. It has a direct impact on an organisation's brand value and its reputation,” says Mr Agrawal.

Why is high quality financial reporting important?

New or amended financial reporting standards have been hitting us fast and furious. Changes in standards have become more complex and affected many areas of accounting. Part 2 of this book offers analysis of changes in standards for fair value measurements, consolidation, financial instruments and revenue recognition. Unsurprisingly, this has led to many who prepare, audit and use financial statements struggling to keep up with the fast-paced developments.

Let's be clear about one point. Nobody wants low quality financial information – not the regulators and certainly not investors and the capital markets. This will make investment decisions even harder and also diminish confidence in Singapore as a trusted international financial centre.

“Our strong reputation as a trusted financial and business hub is a cornerstone of Singapore's drive to stay competitive and remain attractive to investments. With shorter and more volatile business cycles, business decisions are made on the back of financial information that must be accurate, timely and reliable. Companies also gain a competitive edge by leveraging on reliable financial information to grow profitable lines of business, and economising inefficient or non-performing areas of business,” says Kenneth Yap, Chief Executive, Accounting and Corporate Regulatory Authority.

“The globalisation of markets and organisations has increased demand for internationally comparable high quality accounting information. Stakeholders are no longer satisfied with adherence to minimum regulatory requirements and instead look towards genuine corporate transparency. As such, high quality financial reporting is crucial to directors in addressing and meeting these market and stakeholder demands,” says Lee Suet Fern, Senior Director, Stamford Law Corporation.

On the investor front, the consequences for not promoting and delivering high quality financial reporting are clear. Investors of companies can vote with their feet.

“By giving out ambiguous or incomplete or inaccurate information, it will destroy the investor community's trust and shrink demand for the company's securities and drive value down and not up. Incomplete information promotes uncertainty and uncertainty creates risk,” says David Gerald, President and CEO, Securities Investors Association of Singapore.

Professional services firms agree that high quality financial reporting is an important step towards building a more efficient and robust capital market.

“Together with transparency in disclosures, high quality financial reporting minimises information irregularities thus reducing the level of risk premium attached to each investment and the eventual capital cost by helping facilitate well-informed investment and lending decisions. High quality financial reporting also improves corporate governance,” says Chaly Mah, CEO, Deloitte Asia Pacific.

An ecosystem for financial reporting

To advance the financial reporting quality, we must first accept that it involves many participants. Everyone has to work together for the common goal, as part of an evolving ecosystem. Financial reporting as an ecosystem is not a new concept. Like any other ecosystem, it is a system of interconnecting and interacting parts.

At the 2012 CPA Congress, ACRA's chairman Lim Soo Hoon spoke about the four parties in such ecosystem for financial reporting: shareholders, directors, auditors and regulators. Kon Yin Tong, Managing Partner, Foo Kon Tan Grant Thornton, proposed that the ecosystem consists of various constituents that play a part in setting the supply and demand equilibrium for financial information. In the Singapore Accountancy Convention in July 2013, many presenters and panellists spoke of an infrastructure, value chain or ecosystem for financial reporting. Their ideas have formed the basis of developing our representation of an ecosystem for financial reporting.

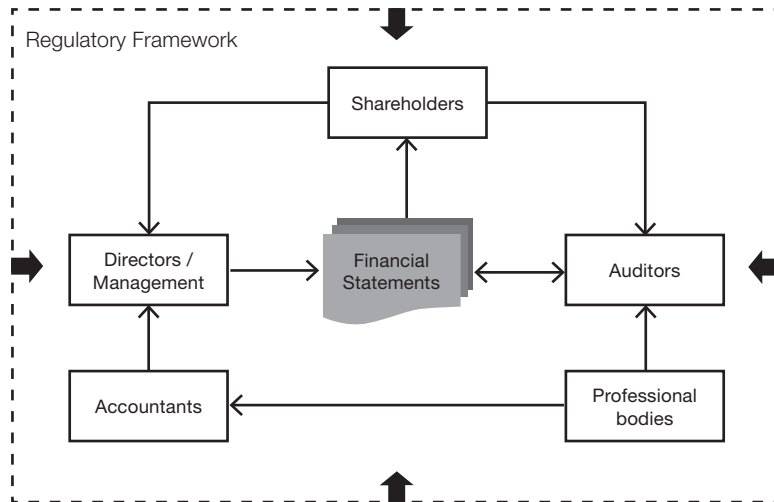


Exhibit 1.1: An ecosystem for financial reporting

The regulatory framework is akin to the environment in which an ecosystem exists. The regulatory framework for financial reporting consists of various agencies that have influences on the behaviours and actions of members of the ecosystems. In Singapore, this is predominantly under the auspices of ACRA, but also includes other bodies such as the Accounting Standards Council (ASC), Monetary Authority of Singapore (MAS), Singapore Accountancy Commission (SAC), and the Singapore Exchange (and its listing rules). On its own, it does not produce financial statements but it creates a suitable environment for all elements to work cohesively together in the best interest of the ecosystem. When necessary, it may exert appropriate nudges (such as imposing new regulations) to the participants of the ecosystem if they are found to be lacking.

Directors are ultimately responsible for financial statements. Section 201 of the Companies Act makes it an obligation for directors to prepare financial statements that comply with applicable accounting standards. They do this through the management team as well as accountants in the finance office. Accountants and auditors with sound technical knowledge and relevant experience are in a better position to prepare and audit, respectively, financial reports. Professional bodies thus play a key part in developing the talent

pool that enters the profession. Its qualification process and commitment to life-long learning through continuous professional development activities help ensure accountants and auditors continue to be relevant and effective. Shareholders should remain proactive in their dealings with auditors, directors and management. Their trust in the company's financial statements must be continuously earned and maintained.

What is being done well now and what needs to be improved?

Financial reporting requirements vary from country to country. This unfortunately creates difficulties in comparability and inefficiencies in cross-border capital flows. As markets and companies globalise, so has demand for internationally comparable high quality accounting information. Observers say now that International Financial Reporting Standards have been relatively successfully adopted, more harmonisation of disclosure standards are in the pipeline with the expected introduction of the ASEAN Economic Community in 2015.

Singapore has had the fortune of having already built a strong foundation for high quality financial reporting. According to the regulator ACRA, Singapore companies in general already understand the need for strong corporate governance which encompasses a system of accounting records, internal controls, financial reporting and auditing.

“On top of self-governance, our regulatory framework aims to ensure that all parties in the financial reporting ecosystem perform their roles effectively in safeguarding the quality of financial information. However, the ecosystem is only as strong as its weakest link. It only takes one ineffective party to destroy trust in the quality of financial information,” says Kenneth Yap, Chief Executive, ACRA.

From a financial reporting standards issuance perspective, there is currently a good framework in place.

“The consultative approach prior to issuing new or revised reporting standards, time lag before the applicability of these revisions coupled with the convergence of reporting standards make the process effective. There is an increased acceptability and awareness of the need for a high quality financial reporting from the professionally managed organisations. In some cases, the accounting standards and enhanced regulations (Basel III) are making some of the key disclosures prescriptive to bring a level of standardisation in disclosure of the financial information.” says Sanjeev Agrawal, CFO (Singapore & Southeast Asia), Standard Chartered Bank.

Admittedly, there is still a lot of work ahead in the journey towards higher quality financial reporting. This includes a need to continue to accelerate the convergence towards global financial reporting standards.

“This would make it easier for the investor community to compare the financial performance of companies across different countries. Preparers of financial statements and those charged with governance will continue to play a critical role in ensuring that financial statements prepared are reliable, accurate and reflect the real economics of transactions,” says Chaly Mah, CEO, Deloitte Asia Pacific.

In Singapore, the pool of trained accountants with the necessary skill-sets and competencies to enhance companies’ reporting processes and preparation of financial statements has grown. Going a step further, enhancing the competence of accounting professionals through professional programmes like the CPA Program by CPA Australia and Singapore Qualification Programme (SQP) will also contribute to improving the quality of audit which is critical to the efficient functioning of capital markets and market confidence.

“One area where accountants can improve is their ability to deliver financial reports which are more user-friendly and easier to understand. Accountants should also develop a stronger understanding of risk, in particular financial risk factors and their corresponding impact on the financial information provided. Within each organisation, the finance function should also seek to continually improve their existing financial reporting systems and processes. Automation reduces the amount of manual work and therefore leads to greater accuracy.

Of equal importance is instilling the right mind-set and culture of high quality financial reporting within the organisation,” says Chng Lay Chew, CFO, Singapore Exchange.

But with the business environment becoming increasingly volatile and uncertain, some argue that a strict focus on financials and compliance with traditional accounting standards is no longer sufficient.

“Substance needs to take precedence over form, and accountants and companies would do well to make the transition to integrated reporting, which would expand the scope of financial reporting to include non-financial and macro-economic indicators of a company’s sustainable value creation. Furthermore, simplicity should be preferred over complexity in preparing financial reports: the process should be principle-based, rather than guided by strict adherence to formal rules which sometimes confuse rather than clarify,” argues Lee Suet Fern, Senior Director, Stamford Law Corporation.

Mindsets about quality financial reporting must also change, especially if companies are trying to improve their engagement with shareholders.

“There is largely a compliance mindset when it comes to financial reporting. Companies do well in complying and reporting the bare minimum, including the use of boiler plates or standard wordings in their financial reports. It is important that companies tailor their financial reports to reflect their adoption or adaptation of the accounting standards. Investors should be given more than just boiler plate financial reports that are only surface deep in terms of substance,” argues David Gerald, President and CEO, Securities Investors Association of Singapore.

As mentioned earlier, everyone along the value chain in the financial reporting ecosystem has a part to play in advancing the quality of financial information. We sought further perspectives from the key stakeholders: regulators, directors, management, auditors, investor bodies and professional bodies.



Kenneth Yap

Chief Executive

Accounting and Corporate Regulatory Authority

What role do you think ACRA, as the regulator, can play in advancing the quality of financial information?

ACRA has a unique advantage of having oversight over the entire financial reporting ecosystem. We can bring together the different players to work towards a common goal. For example, in addition to auditors, audit committees also have a key role in upholding audit quality. We will work with audit committees to place priority on quality and reliability over price in purchasing audit services, to ensure that the audit best serves the interests of investors. Likewise, ACRA will work with professional bodies in providing support to preparers in boosting the quality of their accounting and financial statements.

If preparers can do this, the external auditors can focus on delivering a high quality audit. Ultimately, whether as preparers, auditors, audit committees or regulator, we must work together to ensure that reliable and trusted financial information is made easily available to market users, who can sleep well at night knowing that their business decisions are supported by trusted data.



Lee Suet Fern

Senior Director

Stamford Law Corporation

What role do you think directors can play in advancing the quality of financial information?

Directors, as key decision-makers, are well-positioned to ensure the implementation of high standards throughout the financial reporting process. Directors can work with management to implement a principled, transparent accounting system that effectively collates financial data across the company's supply chain. They can pinpoint what information stakeholders require in financial reports, and communicate this to auditors and management. In fulfilling this function, directors can also utilise investor relations to communicate with stakeholders and tap on analyst feedback.

Directors can also provide feedback on how financial reports are presented, to ensure that financial information is conveyed in a manner that is accurate, fair and meaningful for all shareholders. This involves collaborating with auditors to ensure decreased complexity and greater clarity in financial reporting. Directors provide a more commercially-centred foil to auditors and accountants, who may be more focussed on numbers than on weaving a cohesive narrative with a company's financial data.



Sanjeev Agrawal

CFO (Singapore and Southeast Asia)
Standard Chartered Bank

What role do you think management can play in advancing the quality of financial information?

There are steps that are taken in view of advancing the quality of financial information. For one, management should work closely with regulators and providing constructive feedback on guidelines and reporting standards. Similarly, working with auditors. It is also important to continuously identify the stakeholders with a view of ensuring as far as possible that their needs are met. In that pursuit, we should strike a right balance in between the amount of information provided and quality, and information relevance. Proper messaging around the results is also important, as it is imperative that stakeholders are given the right context for a proper understanding of the financial information.



Chng Lay Chew

CFO
Singapore Exchange (SGX)

What role do you think management can play in advancing the quality of financial information?

SGX as the operator of securities and derivatives markets, and a regulator of listed companies and Member firms, has a key role to play in terms of encouraging and driving efforts towards higher-quality financial information.

By extension, as CFO of SGX, I see my role firstly as the champion of high reporting standards within the company supported by a robust financial reporting framework. We are constantly enhancing our policies and procedures, ensuring that controls in place are effective without compromising efficiency and practicality. We are also constantly automating manual processes and ensuring that roles and responsibilities are clear.

The quality of our accounting talent is crucial and I devote a substantial amount of time on retaining and recruiting qualified accountants with a high level of integrity. I believe that my accounting colleagues should constantly undergo relevant training courses, both internal and external, for their professional development. I also advocate knowledge sharing and encourage my colleagues to mentor each other, and freely provide guidance. I participate in industry conferences and discussions with accounting professionals. These are events where I can be an advocate of higher quality financial reporting.

**Chaly Mah**

CEO

Deloitte Asia Pacific

What role do you think auditors can play in advancing the quality of financial information?

The importance of high quality financial reporting to the investor community cannot be underestimated. Public accounting firms play a critical role in the financial reporting value chain because they provide valuable contributions to those charged with corporate governance responsibilities and an independent stand on key issues - for example, interpreting particular accounting standards and identifying ways to improve internal controls and corporate governance. Globally, public accountants need to continue to participate and have a voice in the setting of standards for accounting and auditing to ensure that financial reporting standards remains relevant to all stakeholders and are of the highest quality.

**David Gerald**

President and CEO

Securities Investors Association of Singapore (SIAS)

What role do you think investor bodies can play in advancing the quality of financial information?

SIAS has embarked on educating investors to understand the importance of high quality financial information and why it is important to them. At SIAS, the investors are taught how to interpret and what they should look out for in a financial statement. Only having good knowledge of what amounts to a high quality financial report, can they demand from the company in which they are invested, the quality of financial report they are expecting. Investors are, therefore, encouraged to read the financial reports carefully and to query the Board on shortfalls. Only when company Boards realise that shareholders are demanding high quality in financial reporting, they will pay special attention to presenting what is expected of them.



Alex Malley
Chief Executive
CPA Australia

What role do you think professional bodies can play in advancing the quality of financial information?

Adjusting to new and evolving international accounting standards can be an uphill task for finance professionals. Professional bodies can play a big role enhancing the ecosystem. In CPA Australia's case, as a global professional body, we are deeply committed to helping our members and the accounting profession through a robust qualification programme and continuing professional development throughout an individual's career. In short, we want to develop quality finance professionals who can meet the demands of industry and contribute meaningfully to improving the quality of financial reporting.

Conclusion

Relevant and faithful financial information forms the core foundation of successful businesses. It enhances public confidence on the health of companies. It helps boards, management and investors make informed decisions. It builds trust in Singapore as an international financial and business hub, making it attractive to foreign investments.

Achieving high quality financial information is not the responsibility of just one party. Everyone along the value chain - shareholders, directors, management, auditors, regulators and professional bodies - all have a part of play in the ecosystem of financial reporting.

Understanding the importance of good financial information is one thing. It is also necessary to equip those who prepare and audit financial statement with the necessary tools to improve processes, as well as continuing to stay up to date on changes in accounting standards. This is where regulators and professional bodies can help to educate, working in tandem with boards and senior management who can set the right tone from the top.

Chapter 2

Understanding Financial Reports

CPA Australia¹

Introduction

Existing and prospective shareholders are entitled to information about the financial performance and state of affairs of the company in which they have invested or may invest. The company's financial report is one important source of that information. Analysts and media commentaries are others. However, the financial report is only useful to those who can understand and interpret the messages conveyed.

What is a financial report?

A financial report provides people who are interested in a company – such as shareholders, lenders, analysts and employees – with information about the financial performance and financial position of the company. It is one means by which directors of the company advise shareholders on how the business has performed during the year. The financial report also provides information to shareholders on how the directors have discharged their responsibilities.

¹*This article was adapted by Wang Jiwei based on CPA Australia's publication titled "A Guide to Understanding Annual Reports".*

Financial reports consist of four primary financial statements for the current financial period and the comparative previous financial period, the notes to the financial statements, the directors' declaration and the audit report.

The four primary financial statements are:

- a statement of comprehensive income
- a statement of financial position
- a statement of changes in equity
- a statement of cash flows

Financial statements present information relevant to the current financial period and comparative figures for the previous year to illustrate how the financial performance and position of the company have changed.

The notes in the financial report explain the accounting policies used in its preparation and provide additional information on many of the amounts. The notes also provide financial information which is not contained in the primary financial statements, such as information about the uncertainties facing the company that meet the definition of contingent liabilities and leasing commitments.

Later in this chapter, we illustrate the possible form and content of the four financial statements and some notes by providing a partial financial report of a fictitious Singapore manufacturing company, CPA Manufacturing Private Limited.

The directors' declaration comprises statements from the directors that:

- the financial statements and the notes comply with accounting standards
- the financial statements and notes give a true and fair view
- there are reasonable grounds to believe that the company is solvent

This declaration is required by the Companies Act Section 201 (15) and has to be signed by two directors of the company on behalf of its board.

What is the audit report?

Auditors are independent accountants appointed by shareholders to provide an independent opinion on the financial report prepared by the directors. The audit report to the financial report comprises two parts. The first part of the report is the auditor's opinion about whether the financial report complies with the Companies Act (and if not, why not), the Singapore Financial Reporting Standards (and if not, the quantitative effect of that non-compliance) and gives a true and fair view of the reported financial performance, financial position and cash flows of the company.

The second part of the audit report is the auditor's opinion about whether all information, explanations and assistance necessary for the audit has been given, whether sufficient financial records have been kept to enable the financial report to be prepared and audited, and whether other records and registers as required by the Companies Act have been kept as well as confirming that the audit was conducted in accordance with Singapore Standards on Auditing. Chapter 5 discusses audit and assurance matters further.

What do the four primary financial statements show?

The primary purpose of financial statements is to aid current and prospective shareholders and other providers of capital in their resource-allocation decisions.

The statement of comprehensive income provides a complete picture of company performance by reporting the total monetary measure of all events that have changed the value of an owner's interest in the company, other than those events with owners when acting in their capacity as owners. The statement of financial position shows the monetary measure of all the resources controlled by a company and all the obligations due by the company at one point in time classified as current or non-current or in order of liquidity. The statement of changes in equity reports all changes to equity during the financial period. The cash flow statement shows the historical cash inflows and outflows for the financial period from operating, investing and financing activities. The content of the four statements is supported by notes to the financial statements.

Financial statements are prepared in accordance with the Singapore Financial Reporting Standards (SFRS) and Interpretations issued by the Accounting Standards Council (ASC). The standards and interpretations provide the principles to follow when accounting for and disclosing transactions and events. Small entities may prepare financial statements in accordance with the Singapore Financial Reporting Standards for Small Entities (SFRS for Small Entities). Chapter 8 examines the SFRS for Small Entities in more detail.

Why is the statement of comprehensive income different from the statement of cash flows?

Companies prepare their financial statements using the accrual basis of accounting. This means the financial effect of a transaction is recorded in the financial statements when the transaction occurs. This may be different from

when the cash relating to the transaction is received or paid. For example, our fictitious company CPA Manufacturing may have entered into a contract to build equipment and will recognise the sale proceeds as revenue when the customer has taken delivery of the equipment, the risks and rewards are transferred to the customer and there is a valid sales contract. However, the cash may not be received until later, which may be after the end of the financial year. Thus, the sale will be included in the statement of comprehensive income for the year and a receivable recognised in the statement of financial position. However, as no cash has changed hands, the proceeds will not be reflected in the statement of cash flows until the next year.

Why are the figures in a financial statement sometimes subject to disputes and disagreements?

Financial statements portray the financial effects of what are often complex commercial transactions. Judgement may be required to determine how some transactions and events are to be represented. Accounting standards play an important part in ensuring that similar transactions are treated in a similar manner. However, a principles-based approach to setting accounting standards means that accounting rules are not written to cover all situations. Therefore, professional judgement may be needed when interpreting and applying an accounting standard.

The monetary amount shown as property, plant and equipment in the statement of financial position is the original cost that the company paid. Directors are also required to use judgement to decide how long an asset will remain useful, the resulting effect on depreciation of property, plant and equipment assets, and whether the asset has suffered any impairment. Judgement is frequently required in determining those amounts and directors will often make use of an external valuation expert.

CPA Manufacturing Private Limited is a fictitious Singapore company with primary operations in Singapore and secondary operations in Australia. These sample financial statements of CPA Manufacturing show the way in which many companies present yearly financial statements. The figures are simplified to assist you in reading the statements. A subset of the notes to the financial statements is provided for illustrative purposes.

CPA Manufacturing Private Limited STATEMENT OF COMPREHENSIVE INCOME For the year ended 30 June 20XC			
	Note	20XC	20XB
Revenue	3	643,066	539,189
Cost of sales		(300,105)	(206,844)
Depreciation		(29,367)	(55,121)
Employee benefits expense		(114,986)	(105,909)
Finance expenditure		(18,779)	(19,408)
Impairment of property, plant and equipment		(114,251)	(103,422)
Other expenses	4	(7,498)	(10,174)
Profit before income tax expense		58,080	38,311
Income tax expense	5	(17,406)	(11,606)
Profit after income tax for the period	24	40,674	26,705
Other comprehensive income			
(Loss) / gain on translation of foreign operations		31	1,678
Other comprehensive income for the period, net of tax		31	1,678
Total comprehensive income for the period attributable to CPA Manufacturing Private Limited		40,705	28,383
Earnings per share for profit from comprehensive income		cents	cents
Basic earnings per share	27	20.62	15.19
Diluted earnings per share	27	20.62	15.19

The statement of comprehensive income should be read in conjunction with the accompanying notes.

CPA Manufacturing Private Limited STATEMENT OF FINANCIAL POSITION As at 30 June 20XC			
	Note	20XC	20XB
Current assets			
Cash and cash equivalents	6	102,801	98,879
Trade and other receivables	7	8,945	5,474
Inventories	8	5,641	7,131
Short-term investments	9	27,370	40,142
Total current assets		144,757	151,626
Non-current assets			
Trade and other receivables	10	42,323	23,021
Property, plant and equipment	11	184,540	201,135
Deferred tax	12	11,353	10,345
Total non-current assets		238,216	234,501
Total assets		382,973	386,127
Current liabilities			
Trade and other payables	13	29,054	4,689
Provisions	14	6,875	37,303
Income tax	15	11,266	4,268
Employee benefits	16	10,428	9,953
Borrowings	17	-	5,700
Total current liabilities		57,623	61,913
Non-current liabilities			
Provisions	18	22,911	8,326
Borrowings	19	18,374	37,476
Deferred tax	20	4,081	3,917
Employee benefits	21	13,626	13,266
Total non-current liabilities		58,992	62,985
Total liabilities		116,615	124,898
Equity			
Contributed equity	22	223,610	223,274
Reserves	23	5,500	5,469
Retained profits	24	37,248	32,486
Total equity		266,358	261,229
Total liabilities and equity		382,973	386,127

The statement of financial position should be read in conjunction with the accompanying notes.

CPA Manufacturing Private Limited
STATEMENT OF CHANGES IN EQUITY
For the year ended 30 June 20XC

	Issued capital	Reserves	Retained profits	Total equity
Balance at 1 July 20XA	128,238	3,791	27,313	159,342
Profit after income tax for the period	-	-	26,705	26,705
Other comprehensive income for the period	-	1,678	-	1,678
Total comprehensive profit for the period	-	1,678	26,705	28,383
<i>Transactions with owners in their capacity as owners</i>				
Shares issued, net of costs	95,036	-	-	95,036
Dividends paid			(21,532)	(21,532)
Balance at 30 June 20XB	223,274	5,469	32,486	261,229
Balance at 1 July 20XB	223,274	5,469	32,486	261,229
Profit after income tax for the period	-	-	40,674	40,674
Other comprehensive income for the period		31		31
Total comprehensive profit for the period	-	31	40,674	40,705
<i>Transactions with owners in their capacity as owners</i>				
Shares issued, net of costs	336	-	-	336
Dividends paid	-	-	(35,912)	(35,912)
Balance at 30 June 20XC	223,610	5,500	37,248	266,358

The statement of changes in equity should be read in conjunction with the accompanying notes.

CPA Manufacturing Private Limited
STATEMENT OF CASH FLOWS
For the year ended 30 June 20XC

	Note	20XC	20XB
Cash flows from operating activities:			
Receipts from customers		619,933	579,800
Payments to suppliers and employees		(529,674)	(501,952)
Interest received		1,325	660
Interest paid		(2,633)	(4,142)
Income taxes paid		(11,264)	(10,341)
Net cash flows from operating activities	26	77,687	64,025
Cash flows from investing activities:			
Proceeds from sale of plant and equipment			7,776
Payments for acquiring plant and equipment		(13,402)	(11,386)
Environmental bonds refunded		-	190
Net cash flows used in investing activities		(13,402)	(3,420)
Cash flows from financing activities:			
Proceeds from issue of shares	22	336	95,036
Repayment of borrowings		(24,802)	-
Dividends paid	25	(35,912)	(21,532)
Net cash used in/from financing activities		(60,378)	73,504
Net increase in cash and cash equivalents		3,907	134,109
Cash and cash equivalents at beginning of period		98,879	(35,240)
Effect of exchange rate changes on cash		15	10
Cash and cash equivalents at end of period	6	102,801	98,879

The statement of cash flows should be read in conjunction with the accompanying notes.

Note 1: Adoption of new and revised accounting standards

The principal accounting policies adopted in the preparation of the financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

New, revised or amending Accounting Standards and Interpretations adopted

The company has adopted all of the new, revised or amending Singapore Financial Accounting Standards and Interpretations issues by the Accounting Standards Council (ASC) that are relevant to the operations and mandatory in the current reporting period. Any new, revised or amending Singapore Financial Accounting Standards or Interpretations that are not yet mandatory have not been early adopted.

Note 2: Summary significant accounting policies (extract)**(a) Basis of preparation**

The financial statements have been prepared on an accruals basis and are based on historical costs and do not take into account changing money values. Cost is based on the fair value of the consideration given in exchange for assets. The accounting policies have been consistently applied, unless otherwise stated. The financial statements are presented in Singapore Dollars and all values are rounded to the nearest dollar unless otherwise stated.

(b) Statement of compliance

The financial statements are general purpose financial statements and have been prepared in accordance with Singapore Financial Accounting Standards and Interpretations issued by the ASC.

(c) Critical accounting judgements, estimates and assumptions

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts in the financial statements. Management continually evaluates its judgements and estimates in relation to assets, liabilities, contingent liabilities, revenue and expenses. Management bases these assumptions on experience and on other factors such as expected future events it believes to be reasonable under the circumstances. The resulting accounting judgements and estimates will seldom equal the related actual results. The judgements, estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

(d) Estimation of useful lives of assets

The company determines the estimated useful lives and related depreciation charges for its property, plant and equipment. The useful lives could change significantly as a result of technical innovations or some other event. The depreciation charge will increase where the useful lives are less than previously estimated lives, or technically obsolete or non-strategic assets that have been abandoned or will be written off or written down.

Note 3: Revenue

	20XC	20XB
Sales revenue	641,741	538,529
Interest	1,325	660
	643,066	539,189

Exhibit 2.1: CPA Manufacturing sample financial statements

Features of the financial statements

The performance report of CPA Manufacturing in Exhibit 2.1 uses the single statement format of the statement of comprehensive income and will always start with revenue.

Note 3 in the statement of comprehensive income identifies the types of revenue earned by CPA Manufacturing. Accounting standards require that the expenses present finance costs and tax expense separately, and the notes would contain further information on some items of expense. For some expenses, the accounting standards allow the company to choose either presenting the information in the statement of comprehensive income or in the notes to the financial statements.

The statement of financial position does not purport to be a valuation of the company. Rather, it is the outcome of applying accounting standards. Therefore, it would be incorrect to conclude that the current monetary value of CPA Manufacturing is \$266,358. Some of the assets of CPA Manufacturing are shown at a current valuation (such as short-term investments), while other assets, such as property, plant and equipment, are presented at their cost of purchase less accumulated depreciation and impairment.

Notes 2(a) and (e) provide some further information about the approach taken by CPA Manufacturing in the preparation of the financial statements. The accounting standards only allow the recognition of purchased goodwill, whereas the goodwill a company builds up during its years of operation is not recognised on the statement of financial position. Although CPA Manufacturing is profitable and has operated for a number of years, its statement of financial position does not include goodwill as it has not purchased other businesses.

CPA Manufacturing classifies its assets and liabilities presented in the statement of financial position as current or non-current. The distinction is based on an assessment of the expected timing of recovering or settling the amounts. An item will be classified as “current” when its amount is expected to be recovered or settled no more than 12 months after the date of the report, otherwise its classification is as “non-current”.

Some companies may choose to classify their assets and liabilities only in order of liquidity and not separately presented as current or non-current, while others may use a combination of liquidity and current or non-current classifications.

The equity section of the CPA Manufacturing’s statement of financial position includes capital invested by shareholders and accumulated profits retained from previous years not yet paid out as dividends. The equity section also include reserves that result from the accounting standards requirements for asset revaluations, the designation of financial assets as available for sale, cash flow hedges and foreign currency translations. Some reserves are available for distribution to shareholders.

Larger companies will sometimes control other companies. In those situations, the financial statements of the controlling company show information for the consolidated group. The equity section of the statement of financial position would separately present equity attributed to the shareholders of the controlling company, and the non-controlling interest.

The statement of changes in equity shows the overall change in equity during a period which represents:

- the total amount of income and expenses, including gains and losses, generated by the company’s activities during that period
- the changes resulting from transactions with owners acting in their capacity as owners and associated costs. In the current financial year, CPA Manufacturing activities with its owners are the issue of new shares at \$336 and the payment of dividends of \$35,912.

The statement of cash flows shows movements of cash (cash on hand and demand deposits) and cash equivalents (short-term, highly liquid investments that are readily convertible to cash). It highlights the sources and uses of cash and cash equivalents, and analyses the areas of CPA Manufacturing activity based on three types of activities: operating activities, investing activities, and financing activities.

The information in a statement of cash flows about cash and cash equivalents including their source can be used to assess the company's ability to meet its financial commitments, fund its activities and generate positive cash flows in the future.

An approach to reading financial statements

Financial statement reporting is all about communicating monetary measures and supporting information to current and prospective shareholders and other providers of capital. Other stakeholders, including analysts and employees, may also be interested. Some parts of the story might be of interest to all, while other parts will be of interest to a particular group. Also, those readers planning to use the financial statements to make decisions need to be aware that a company's financial statements do not and cannot provide all the information they need. Analysts' reports, the financial press, and the SGX website are other sources of information to assist decision-making.

Understanding financial statements:

- Get to know the company and industry in which it operates in
- Examine the four financial statements
- Review accounting policies
- Review other notes to the accounts
- Check the audit report

A final warning – financial statements are not designed to show the market value of the company but they do provide information to assist shareholders, other providers of capital and other stakeholders in estimating that value.

Step 1

The importance of preparation should not be underestimated as you settle down to analyse the financial statements of a company. Making yourself knowledgeable about the environment in which the company operates in now and its direction in the future, for example getting information about local, national or global macro and micro economic conditions and the risk profile of the company's business(es), is a good and necessary start. Returning again to our fictitious Singapore manufacturing company example, the current and prospective shareholders of CPA Manufacturing are likely to be interested in the projected international demand for its products. Most readers gain an overview of the company, an understanding of the business it is in and the risks the business is facing from reading other parts of the annual report. The statements from the chairman and the Chief Executive Officer (CEO) that put the company's performance highlights into context against strategies and the directors' report are often read. Readers should be mindful that statements from the chairman or CEO may highlight the positive side of the company's operations and that none of this information is subject to the opinion of the auditor.

Step 2

Next, have a look to the statement of comprehensive income and the statement of financial position and assess the size of the company and its profitability. CPA Manufacturing generated profit after income tax for the current period of \$40,674. But this figure means little unless we compare it to another time period or another company to give it context. Horizontal or trend analysis can be used for intra-company comparative analysis. For example, you might decide to evaluate performance by using the comparative information in the CPA Manufacturing financial statements to benchmark the current year performance (profit after income tax \$40,674 compared to the previous year figure of \$26,705). Vertical analysis can be used for intra-company and inter-company comparative analysis. A base amount is established and the monetary measure in the current period financial statement of CPA Manufacturing would be expressed as a percentage of this base amount.

For example, you might be interested in the relationship of cash and cash equivalents to total assets and how they compare to the previous year. For the current financial year, the relationship expressed as a percentage is 26.8 per cent (and the comparative financial year 25.6 per cent). Ratio analyses compares the relationships of financial statement information and are worked out by dividing one monetary measure by another and can be used for intracompany and intercompany comparative analysis. For example, CPA Manufacturing has current period current assets of \$144,757 and \$57,623 in current liabilities, a current ratio of 2.51:1. You can use the outcomes from performing horizontal, vertical and ratio analysis to compare the results for the previous year, the industry sector or competitors. You can use the web to increase your understanding of how to use these tools.

Now consider the statement of cash flows and the information this provides on the company's cash and cash equivalents transactions and position.

For companies of some sectors such as property, banking and insurance, the current and prospective shareholder is likely to pay particular attention to the statement of financial position, while retaining a focus on the statement

of comprehensive income. For companies of other sectors, it is more likely that current and prospective shareholders will be interested in the statement of comprehensive income. This is because they reason that an understanding and assessment of the economic productivity of the company is more important to estimating performance which in turn will determine their actions of buy, sell or hold.

Step 3

Turn to the notes to the financial statements. For example, Note 2 to the financial statements of CPA Manufacturing states the basis of preparation for the financial statements are on an accruals basis and are based on historical costs and do not take into account changing money values. Cost is based on the fair value of the consideration given in exchange for assets. Further, the accounting policies have been consistently applied, unless otherwise stated. Read the accounting policies which are used for any items which have attracted your attention in the financial statements. Look for accounting policies which have changed during the year, the reasons for the change and effect of the change on the financial statements. Companies are required to provide information on changes to accounting policies in the notes.

Step 4

The remaining notes to the financial statements contain detailed financial information, including information on the areas in which the company operates, specific items of revenue and expense, and an explanation of the tax expense. Again, look for the notes which elaborate on any amounts which have come to your attention in the financial statements.

Step 5

Read the audit report to see if the audit opinion has been modified or contains some other communication by the auditor. If so, read carefully why the auditor has issued a modified opinion or included another communication such as an emphasis of matter paragraph.

Conclusion

Financial reports communicate important information about a company's financial performance and financial position to its stakeholders. All business owners and investors need to understand financial reports. Such an understanding will help to speed up the dissemination of information, reduce information asymmetry and lower a company's cost to access capital. The list of references and further reading below include additional examples and guides on reading financial statements.

References and further reading

CPA Australia (2012), "A Guide to Understanding Annual Reports" [URL](#)

Deloitte (2012), "Singapore Illustrative Financial Statements 2012" [URL](#)

Ernst & Young (2012), "Singapore Illustrative Financial Statements 2012" [URL](#)

ICAEW (undated), "Financial Ratios" [URL](#)

KPMG (2012), "Singapore Illustrative Financial Statements 2012" [URL](#)

Loth, R (undated), "Financial Ratios Tutorial", *Investopedia* [URL](#)

PricewaterhouseCoopers (2012), "Building Trust, Creating Value: Illustrative Annual Report 2012" [URL](#)

Singapore Exchange (undated), "An Investor's Guide to Reading Annual Reports" [URL](#)

Tan, L (2009), "How to Read an Annual Report", *The Sunday Times*, 18 October 2009

Chapter 3 Financial Reporting: Myths and Realities

Themis Suwardy, Singapore Management University

Introduction

In keeping with Singapore's ambition to be an international financial centre, the Republic's financial reporting standards have been harmonised in 2003 with International Financial Reporting Standards (IFRSs), as issued by the International Accounting Standards Board (IASB). It did so on the grounds that benefits would flow to Singapore's economy. The Singapore Accounting Standards Council (ASC) believes that convergence with international accounting standards would achieve greater transparency and comparability of financial information among companies and help lower compliance costs for companies investing in Singapore as well as local companies going overseas.

Whilst Singapore's full alignment with IFRS has been delayed to no earlier than 1 January 2015, Singapore's own Financial Reporting Standards (SFRS) are, in general, consistent with their equivalent IFRSs in all material aspects.

Businesses know they must prepare financial statements in accordance with applicable accounting standards. It is enshrined in the Companies Act and is clearly part of the duty of directors to ensure financial statements are prepared, audited and filed properly (see Chapter 4 on *Governance of Financial Reporting*). Some do so grudgingly, looking for the cheapest, fastest, easiest way to prepare, audit and file their financial statements. These may be fuelled by some myths about financial reporting and accounting standards.

Many in academia and professional and regulatory bodies have written to try to dispel these myths. Professors Mary Barth, Katherine Schipper, Ann Tarca and others have spoken many times on this matter. Hans Hoogervorst, Chairman of the IASB, did the same when opening the IFRS Foundation's regional office for Asia-Oceania in Tokyo in November 2012. Philippe Danjou, an IASB member, wrote extensively and passionately in response to “ten great misconceptions of IFRSs” by commentators earlier this year. CPA Australia published a report titled “In Defence of IFRS”, also in an attempt to dispel some myths about IFRS and financial statements produced under IFRS.

What are the common misconceptions about financial reporting? How real are they? Like most urban legends, there are many variations to these myths. In this chapter, we will examine some of the prevalent ones. We will also attempt to provide a summary of the main arguments for both sides and propose that much of the misunderstanding stem from not having an adequate understanding the objectives of financial reporting. In the arguments, we will refer to the *Conceptual Framework for Financial Reporting*, which was last revised by IASB in September 2010. The IASB is actively working to enhance the *Conceptual Framework* and as such, further refinements can be expected. This paper is up to date as at the IASB meeting in April 2013.

Claim #1: “Management do not use financial statements”

This is a tricky one. Management definitely care about financial statements. Their shareholders measure their performance based on the results presented in the financial statements. Their bonus may depend on some form of return targets based on numbers in the financial statements. They may have debt covenants that are based on the financial statements. But it is also true that management do not rely on financial statements to run their businesses.

The *Conceptual Framework* states that “the objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.” As such, financial statements offer a mechanism for an evaluation of the management's overall efficiency and effectiveness in using an entity's resources.

Management should have, at their disposal, significantly far more information than what is disclosed in the financial reports. Financial statements, as reported, audited and eventually filed/distributed, will not be able to offer the level of granularity and relevance to guide managers for their day-to-day business operations. It is like saying Singapore Airlines should add two more daily flights to Melbourne, or overhaul its customer loyalty programme, just by looking at its financial statements.

In fact, some accounting standards now require management to show how they use financial information. In recent years, IASB has begun to formally incorporate the concept of “business models” into financial statements. For example, to help users better understand the various segments in the business, IFRS 8 (SFRS 108 in Singapore), entities are required to present segment operating information “through the eyes of management”. Similarly, this business model concept is already in the accounting standards for financial instruments, investment properties, presentation of financial statements and many others. In its April 2013 meeting, the IASB confirmed that it will consider how an entity conducts its business activities in developing new or revising standards.

Claim #2: “Financial statements do not matter”

First, if they really do not matter, then we have wasted significant resources over 500 years producing them. One of the more common reasons put forward is that financial statements have little impact on stock price movements or that few investors ask about them in annual general meetings when annual reports are distributed. As Warren McGregor (CPA Australia, 2013) states: “This is probably driven more by when the financial report is released – up to three months after the end of the annual reporting period ... Investors and analysts focus on information that is provided on a timely basis, such as earnings releases and investor presentations.” Thus, annual reports, with audited financial statements, are primarily used to confirm the information already contained earlier earnings releases and to provide additional comfort that they have been subjected to the auditor’s scrutiny. On their release, there really should not be any new material information that is not known by the market participants that would cause any stock price reaction.

So how important are financial statements? PricewaterhouseCoopers studied hundreds of investors from UK, US, Canada, Germany, Australia and France in 2007. The study showed that investors place great emphasis on the financial statements and notes, as well as segmental information. There are clearly more things that we can do to improve financial reporting and disclosure, as shown by the gap between importance and adequacy in Exhibit 3.1, but as a whole, the report concludes that financial statements are the “bedrock of financial analysis” and they are essential in sustaining “strong and effective capital markets”.

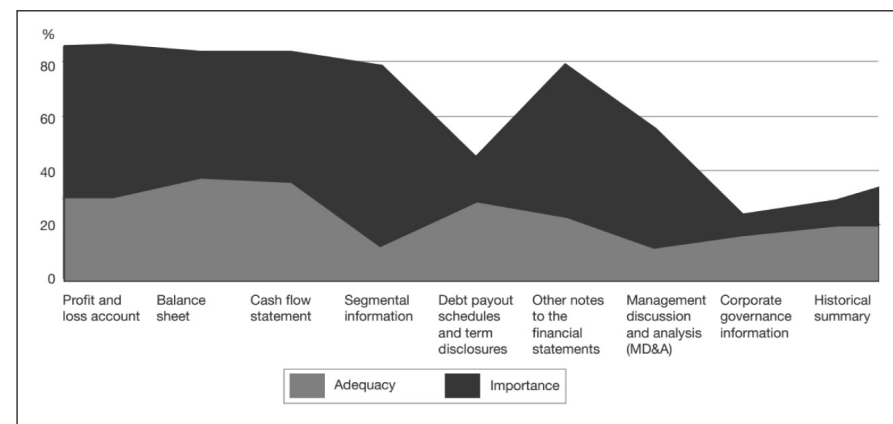


Exhibit 3.1: Importance and adequacy of financial reports (PwC, 2007, page 8)

Another variation on this myth is that financial statements are not useful as they leave out (or put in) things investors and analysts do not like. A classic argument used to diminish the importance of financial reporting is to cite the difference between an entity’s book value (the net assets reported on its statement of financial position) and the market value (as measured by market capitalisation). The critics point to this difference as the failure of accounting to denote the “value” of an entity. This interpretation is wrong, as the *Conceptual Framework* clearly states: “General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity”.

Philippe Danjou (2013) elaborated further: “To the IASB, it is clear that the purpose of IFRS financial statements is not to disclose the aggregate resale value of the entity, even though much of the identifiable assets and liabilities would be recorded at fair value. The sole objective is to help users to assess the future cash flows generated from operations, which can then be compared with future investment requirements in order to determine the available cash flow to be assigned to a return on investment or to a debt repayment. Moreover, as IFRSs do not allow an entity to recognise in the balance sheet intangible assets generated internally by business operations, any attempt to state the aggregate value of the business would fail. An entity is to be reported as a whole at market value only when it is acquired by another entity and consolidated in the accounts of the latter. Identifiable assets and liabilities, which partly account for the purchase price, are assumed by the acquiring entity at their fair value, and the difference (often material) with the purchase price is the goodwill.”

This is reinforced by Hans Hoogervorst, Chairman of IASB, in a speech late last year: “One persistent myth about the IASB is that we (perhaps secretly) would only be interested in fair value. The truth is that we have always been proponents of a mixed measurement model. We understand full well that while fair value measurement is very relevant for actively traded financial instruments, for a manufacturing company it does normally not make a lot of sense to fair value its property, plant and equipment.”

Let’s return again to the *Conceptual Framework* on what financial statements are supposed to represent. It cautioned that financial statements “do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.”

Financial statement users should be free to make whatever analytical adjustments they believe are necessary before arriving at their conclusions. Analytical adjustments do not mean the financial statements are not useful. For example, many analysts add back capitalised interest in calculating an entity’s interest coverage ratio. Similarly, some analysts remove certain income lines (such as revaluation gains and one-time gains or losses) to arrive at a more conservative profit figure. Different analysts and users have different risk profiles and would tailor their analytical adjustments accordingly. Investors and analysts are entitled to their own style of evaluating a company’s performance.

Where there is room to improve the reporting, we improve the accounting standards as a whole, not just for a particular type of users. For example, the proposed new standards on leases (as issued in May 2013) would allow users to better understand the corresponding assets and liabilities resulting from a lease contract of 12 months or longer. Whilst this is causing some grief to the business community, bringing long-term commitments on the books is conceptually a sound approach.

What is important is a set of financial statements that are (as much as possible) comparable, prepared under one globally-accepted set of financial reporting standards. Professor Ann Tarca’s research supported this argument. “The expected benefits of global accounting standards are compelling. The use of one set of high quality standards by companies throughout the world has the potential to improve the comparability and transparency of financial information and reduce financial statement preparation costs. When the standards are applied rigorously and consistently, capital market participants will have higher quality information and can make better decisions. Thus markets allocate funds more efficiently and firms can achieve a lower cost of capital.” She added, “High quality standards that can improve the quality and comparability of financial reporting and promote the development of national capital markets and the integration of markets internationally.”

Claim #3: “Financial statements are just too complex”

There are actually two things at play when it comes to this claim. An ACCA report in 2009 provides a good starting point to understanding complexity. It says, “Complexity can originate from the intricacy of commercial transactions and events themselves. The accounting for such transactions, by its very nature, is complicated and is therefore beyond the control of standard setters. It is therefore imperative to acknowledge and distinguish two types of complexity in financial reporting from the outset: that which is inescapable, owing to the inherent complexity of certain transactions, and that which could be avoided, having been brought about by accounting standards themselves.”

Let’s think about the first aspect for increased complexity. Complexity in financial statements is a result of the economic phenomenon they attempt to portray. Some of us reminisce about the days when 100 pages are enough to print all accounting standards we need to know. Unfortunately, businesses have increased so much in complexity that there is simply more economic phenomenon to recognise, measure and present in the financial statements. Consider these issues: how to make money from the sale of virtual currencies to buy virtual goods and how to recognise income and performance obligation from such transactions. Zynga, the maker of popular games such as *Farmville*, *Words with Friends* and many others, does exactly this. This sort of business model would have been unheard of 10 or even five years ago. Another example would be the complexity of financial instruments or other types of arrangements that businesses enter into.

Second, there is a view that we need to simplify (or at least clarify) our reporting practices. This is not a bad idea. In fact, Miller (2010) shows that more complex (longer and less readable) reports are associated with lower overall trading of a company’s stocks. KPMG and the Financial Executive Research Foundation (FERF) studied 25 Fortune 100 companies between 2005 and 2011 and noted that overall disclosures have increased by 16 per cent and the footnotes to the accounts have increased 28 per cent (KPMG and FERG, 2011).

In June 2012, Jim Castellano, chairman of Baker Tilly International, spoke at its annual summit. He said “Disclosure has ballooned in recent years with companies and governments required to provide more and more financial information. This additional complexity is hindering the very purpose of financial reporting - to provide shareholders, creditors and other users with useful information. The profession needs to stand back and make financial reports simpler and easier to understand.”

The IASB is well aware of the challenges of “disclosure overload”. Philippe Danjou (2013) wrote, “The Board has already initiated a short and medium-term action plan to resolve the sensitive issue of the excessive amount of notes to consolidated accounts. This may require amendments to standards, but above all, changes in the behaviour of those preparing financial statements, as well as the statutory auditors, and the market regulators: the preparation of notes to financial statements should no longer be considered solely as a compliance exercise, the materiality concept should be better used, and the notes should not be crowded with irrelevant information or immaterial amounts.”

KPMG recently published a collection of interviews with standard setters, user groups, preparers, regulators and auditors in a report titled “The Future of Corporate Reporting”. Many interviewees expressed their dissatisfaction with the prevalent “boiler plate” approach of reporting. A boiler plate is an inconsequential, formulaic, or stereotypical language that adds volumes but offers little meaning. Russell Picot of HBSC said “You get a long description and a lot of numbers but I think there are not many good examples of disclosures showing how a company has responded to changing risks and its use of relevant metrics”.

In January 2013, the IASB released highlights of a survey conducted recently on financial information disclosures and conducted a public forum on “Disclosures in Financial Reporting”. In June 2013, Hans Hoogervorst, Chairman of the IASB, suggested a ten-point plan to deliver tangible improvements to disclosures in financial reporting.

1. We should clarify in IAS 1 (Presentation of Financial Statements) that the materiality principle does not only mean that material items should be included, but also that it can be better to exclude nonmaterial disclosures. Too much detail can make the material information more difficult to understand—so companies should proactively reduce the clutter! In other words, less is often more.

2. We should clarify that a materiality assessment applies to the whole of the financial statements, including the notes. Many think that items that do not make it onto the face of primary financial statements as a line item need to be disclosed in the notes, just to be sure. We will have to make clear that this is not the case. If an item is not material, it does not need to be disclosed anywhere at all in the financial statements.

3. We should clarify that if a Standard is relevant to the financial statements of an entity, it does not automatically follow that every disclosure requirement in that Standard will provide material information. Instead, each disclosure will have to be judged individually for materiality.

4. We will remove language from IAS 1 that has been interpreted as prescribing the order of the notes to the financial statements. This should make it easier for entities to communicate their information in a more logical and holistic fashion.

5. We could make sure IAS 1 gives companies flexibility about where they disclose accounting policies in the financial statements. Important accounting policies should be given greater prominence in financial statements. Less important accounting policies could be relegated to the back of the financial statements.

6. At the request of many users around the world, we will consider adding a net-debt reconciliation requirement. Not only would this provide users with clarity around what the company is calling 'net debt' but it also consolidates and links the clutter of scattered debt disclosures through the financial statements.

7. We will look into the creation of either general application guidance or educational material on materiality. Doing so should provide auditors, preparers and regulators with a much clearer, more uniform view of what constitutes material information. We want to work with the IAASB (International Auditing and Assurance Standards Board) and IOSCO (International Organization of Securities Commissions) on this important matter.

8. When developing new Standards, we will also seek to use less prescriptive wordings for disclosure requirements. Instead, we will focus on disclosure objectives and examples of disclosures that meet that objective. In recent Standards we have already started doing this, creating more explicit room for judgement on materiality.

9. During the second half of 2013, we will begin a research project to undertake a more fundamental review of IAS 1, IAS 7 (Statement of Cash Flows) and IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors). This project will revisit some of the work we already did in the Financial Statement Presentation project. The goal will be to replace those Standards, in essence creating a new disclosure framework.

10. Finally, once the review of these Standards has been completed, we will then undertake a general review of disclosure requirements in existing Standards.

Exhibit 3.2: Breaking the boilerplate (Hans Hoogervorst, 27 June 2013, adapted)

We can thus expect more work on this matter in the coming year. In the mean time, all of us have a role to play to help communicate financial information in a clearer and more concise way. Back in 1998, the U.S. Securities and Exchange Commission (SEC) published a quick checklist for “plain English” disclosures. Clearly, this advice remains extremely relevant.

Do:	Don't:
<ul style="list-style-type: none"> • Use clear and concise sections, paragraphs, and sentences • Use descriptive headings and subheadings • Use definite, concrete, everyday language • Use active voice • Use tabular, graphical, or bullet-list presentations of complex information • Design the documents for visual clarity and readability 	<ul style="list-style-type: none"> • Use highly technical business terms • Use multiple negatives • Use vague “boilerplate” explanations • Use complex information copied from legal documents without any clear and concise explanation of the underlying meaning • Repeat disclosures in different sections if the repetition does not enhance information quality

Exhibit 3.3: SEC's plain English rules (adapted)

The extreme end of simplification, however, is not feasible. The idea that anyone can pick up and comprehend any company's financial statements is just too naïve. Accounting is a language. It is the language of business that keeps on evolving and becoming more complex. The more complicated the business is, the higher the level of mastery of the language would be needed.

The *Conceptual Framework* acknowledges this clearly. It states “Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently...”, and “... at times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena”.

Conclusion

Like most myths, folklores and urban legends, there are perhaps some small dosage of truths and realities in these claims about financial reporting. However, when examined closely, they have been fuelled by embellishments to the point that they often depart significantly from reality. Yes, there is always room to improve financial reporting and educating readers about the objectives of financial statements. But this does not mean financial statements are not useful.

References and further reading

ACCA (2009), “Complexity in Financial Reporting” [URL](#)

Baker Tilly International (2012), “Complexity Hindering Purpose of Financial Reporting” [URL](#)

CPA Australia (2013), “In Defence of IFRS Financial Statements” [URL](#)

Danjou, P (2013), “Answering Ten Great Misconceptions about IFRSs” [URL](#)

Hoogervorst, H (2013), “Breaking the Boilerplate”, speech at the 2013 IFRS Conference, Amsterdam [URL](#)

IASB (2010), “Conceptual Framework for Financial Reporting” [URL](#)

IASB (2013), “Joint Effort Needed to Tackle Disclosure Problem” [URL](#)

KPMG and FERF (2011), “Disclosure Overload and Complexity: Hidden in Plain Sight” [URL](#)

KPMG (2013), “The Future of Corporate Reporting” [URL](#)

Miller, B (2010) “The Effects of Reporting Complexity on Small and Large Investor's Trading”, *The Accounting Review*, 85(6), pp. 2107-2143.

PricewaterhouseCoopers (2007) “Corporate Reporting: Is it what investment professionals expect?” [URL](#)

Tarca, A. (2013), “The Case for Global Accounting Standards: Arguments and Evidence” [URL](#)

U.S. Securities and Exchange Commission (1998), “A Plain English Handbook” [URL](#)

Chapter 4

Governance of Financial Reporting

Gary Pan & Seow Poh-Sun, Singapore Management University

Introduction

In response to global financial turbulences over the past few years, regulators around the world have called on companies to improve their corporate governance practices. Corporate governance is defined as “the system by which companies are directed and managed” and it “provides the structure through which companies achieve their objectives and provide accountability to stakeholders” (Corporate Governance Council of Singapore, 2012a). A key objective of corporate governance is to safeguard the integrity of the company’s financial reporting process in order to provide reasonable assurance that the financial statements give a true and fair view of the company’s operations and finances.

Good corporate governance protects the interests of key stakeholders and enhances corporate performance. An important pillar of good corporate governance is the Board of Directors. Directors of a company have a legal and fiduciary responsibility to manage governance risks. Directors must be vigilant in managing risks which may impact the company’s operations and financial statements. The Board is ultimately responsible for ensuring the reliability of the financial reporting.

The next section presents an overview of the corporate governance regulatory framework in Singapore. Subsequent sections will discuss the importance of internal control over financial reporting, portfolios of internal control and internal control maturity model.

Overview of governance regulatory framework in Singapore

The corporate governance regulatory framework in Singapore can be divided into two categories: legal regulation and best practices.

Legal regulation includes the Companies Act, and companies listed on the Singapore Exchange must also comply with the SGX-ST Listing Manual. Non-compliance with the Act and the listing rules can result in criminal and civil liabilities for the directors of a company.

Under Section 157 of the Act, directors are required at all times to act honestly and to use reasonable diligence in the discharge of duties. Directors must act in good faith in the best interest of the company and exercise reasonable care and skill in undertaking responsibilities. Directors also have a duty to avoid conflicts of interest and are required to make full and proper disclosure of conflicting interests. Furthermore, the Act has provisions under Section 199 for directors to govern the proper maintenance and audit of accounting records. For listed companies, it is mandatory to have audit committees to oversee the financial reporting process.

The main source of best practices in Singapore is the revised Code of Corporate Governance 2012 (Corporate Governance Council of Singapore, 2012b). Non-listed companies may voluntarily refer to the Code to adopt appropriate best practices. On the other hand, listed companies must state their corporate governance practices in their annual reports with reference to the guidelines set out in the Code. If there are any deviations from the Code, listed companies must disclose appropriate explanations (Singapore Exchange, 2012). The revised Code took effect for annual reports commencing from 1 November 2012.

The Code was first introduced by the Corporate Governance Committee in 2001. The Council on Corporate Disclosure and Governance made the first revision to the Code in 2005 and Monetary Authority of Singapore (MAS) announced the latest revision on 2 May 2012. The revised Code contains 16 principles and each principle comprises several guidelines.

One of the changes in the revised Code relates to risk management and internal control. Principle 11 of the revised Code states that the Board is responsible for the governance of risk. Under Principle 11, there are two guidelines (Guidelines 11.2 and 11.3) that are related to the financial reporting process.

Guideline 11.2 recommends that the Board should, at least annually, review the adequacy and effectiveness of the company's risk management and internal control systems, including financial controls. After the review, Guideline 11.3 proposes that the Board should comment on the adequacy and effectiveness of the company's risk management and internal control systems, including financial controls, in the company's annual report. The Board should also comment on whether it has received assurance from the chief executive officer and the chief financial officer that the financial records have been properly maintained and the financial statements give a true and fair view of the company's operations and finances.

The Board typically delegates its oversight responsibility for internal control and risk management to its Audit Committee. The revised Code suggests that the Board establishes an audit committee under Principle 12. Guideline 12.2 proposes that at least two members, including the audit committee chairman, should have recent and relevant accounting or related financial management expertise.

A key role of an audit committee under Guideline 12.4(a) includes reviewing the significant financial reporting issues and judgments to ensure the integrity of the financial statements of the company and announcements relating to the company's financial performance. The audit committee also reviews both the effectiveness of the company's internal audit function and the scope and results of the external audit.

Internal control over financial reporting

In light of recent scandals in various parts of the world such as Enron, WorldCom and Satyam, internal control over financial reporting has attracted much public attention and grown in importance. Effective internal control provides reasonable assurance regarding the reliability of financial reporting and preparations of financial statements. Besides, Goh and Kim (2013) further suggest that internal control over financial reporting improves firm operational efficiency. Effective internal control not only helps external users make more informed decision but also aids firms' internal users in making better operational decisions. They also show that the greater operational efficiency achieved from having effective internal control can partially help offset the compliance costs of the Sarbanes-Oxley Act Section 404 in the United States.

Financial reports are an aggregation of several business process cycles. Each process cycle requires proper controls built into it for financial reports to be reliable. For instance, the implementation of segregation of duties and general IT controls are pervasive controls applicable in all business processes. Nevertheless, while most would agree effective internal controls ought to be enacted in all process cycles, the truth is many companies do not place enough emphasis on sound internal control systems. This may be attributed to limited financial resources and/or an underestimation of the importance of internal control. It is imperative the misconception must change.

Why implement internal control?

- Help align objectives of the business
- Safeguard assets
- Prevent and detect fraud and error
- Encourage good management
- Allow action to be taken against undesirable performance
- Reduce exposure to risks
- Ensuring proper financial reporting

Managers must be active and vigilant in enacting effective internal control over financial reporting. CPA Australia (2008) published a detailed guidebook on internal controls for small business (link available at the end of this chapter). It offers the following guidance on financial controls.

Financial controls

It is important for a business owner to have a strong set of controls in place, especially when the business is growing and it is harder to stay in touch with what is going on at a grass-roots level. Effective controls and reporting of key financial information enables the owner to manage the business without getting bogged down in the detail.

Some points to consider include:

- Is a chart of accounts used? Is it detailed enough to give adequate management information and compliance, or indeed too long and complex?
- Who approves journal entries and credits?
- Who is responsible for producing financial information? Are reasonable due dates imposed? Are the books and records kept up-to-date and balanced?
- Does the owner use budgets and cash projections? Are they compared to actual results? Are major discrepancies investigated?
- Is staff cross-trained in accounting functions?
- Are storage facilities safe from fire or other physical peril?
- Is access to accounting records restricted where appropriate?
- Is insurance coverage reviewed regularly?
- Is there a records retention schedule used?

Exhibit 4.1: Setting up financial controls (CPA Australia, 2008, adapted)

Besides crafting a corporate governance culture that promotes accountability and effective internal control, managers may adopt a portfolio of internal controls: policy controls, disciplinary controls, rewards controls, standards controls, vigilance controls and education controls. The table below summarises portfolios of internal control and offers some examples of effective internal control for each control category.

Control Category	Examples
Policy	<p>Policy controls represent internal control policy statements and guidelines that chart the overall corporate governance direction and set the 'tone from the top'.</p> <ul style="list-style-type: none"> • Corporate ethics on accepting and giving of gifts and conflict of interest declaration policy. • Cash receipts policy that specifies incoming checks must be restrictively endorsed, "for deposit only" with the organisation's account number, when received.
Disciplinary	<p>Disciplinary controls emphasise what people have committed in their failure to fulfill required governance standards.</p> <ul style="list-style-type: none"> • Management takes appropriate disciplinary action in response to departures from approved policies and procedures or violations of the code of conduct by issuing warning or demotion of authorities. • Employment termination and legal action that involve tough penalties against offences such as bribery, misappropriation of funds and conversion of funds and property for personal use.
Rewards	<p>Rewards controls focus on providing incentives to employees in aligning their behaviours to meet governance objectives.</p> <ul style="list-style-type: none"> • Monetary rewards for reporting inappropriate behaviours. • Reward employees who demonstrate honesty on a consistent basis. Consider various options, such as additional paid time off, gift cards or awards of recognition, including plaques and certificates.

Control Category	Examples
Standards	<p>Standards controls refer to external guidelines that influence individual actions within the company that comply with generally understood rules for ethical behaviour.</p> <ul style="list-style-type: none"> • The pursuit and maintenance of accreditation (e.g. ISO 9001). • Adopt the Global Reporting Initiative (GRI) G3.1 Guidelines in sustainability reporting. GRI is a non-profit organisation that promotes economic sustainability. It produces one of the world's most prevalent standards for sustainability reporting. GRI seeks to make sustainability reporting by all organisations as routine as, and comparable to, financial reporting.
Vigilance	<p>Vigilance controls involve monitoring employees' behaviour within the organisation and looking out for inappropriate behaviours.</p> <ul style="list-style-type: none"> • Raising red flags when purchase orders are frequently found to be close to a certain threshold, which could be a sign that the employee is trying to avoid the requirement of management approval. • Segregation of duties is critical to effective internal control. The person who requisitions the purchase of goods or services should not be the person who approves the purchase.
Education	<p>Education controls improve overall control consciousness through experiential-based learning which needs to be encouraged and facilitated so as to ensure learning from past experiences takes place.</p> <ul style="list-style-type: none"> • Learning from prior risk prevention and response experiences. • Conducts ethics training and creates a self-accountability paradigm within the organisation.

Exhibit 4.2: Portfolios of internal control

Internal control maturity

It is vital for companies to improve firm-wide risk management, cultivate a risk-aware culture and instill stronger internal control (Hoitash et al., 2009). Companies may start by first assessing their preparedness and maturity to implement internal control mechanisms. A control maturity model is useful to provide a roadmap for companies who want to implement internal control mechanisms in their financial reporting processes. Exhibit 4.3 describes an internal control maturity checklist which captures the progressive levels of preparedness needed to implement and manage internal control over financial reporting.

Level 1: Implemented ad-hoc controls

- ☑ Implemented several ad-hoc internal controls (i.e. general, application, process) in the business process

Level 2: Planned and charted overall control direction

- ☑ Conducted risk assessment exercise
- ☑ Devised short, medium and long term strategies

Level 3: Designed a sophisticated control environment

- ☑ Devised control policies and procedures
- ☑ Established communication channels

Level 4: Detected control anomalies

- ☑ Implemented rigorous control techniques (i.e. conduct periodic control audits, engage forensic specialists and implement a fraud/bribery hotline)

Level 5: Improved control consciousness

- ☑ Conducted experiential-based learning
- ☑ Established mechanisms to encourage self-reflection

Exhibit 4.3: Internal control maturity model

Control redundancy and inadequacy are common features for companies in level 1 of the internal control maturity model. These companies lack planning and do not have proper coordination when implementing controls. Often, their implementation of controls tends to be on an ad-hoc basis.

Companies must set up an internal control over financial reporting strategy and chart overall control direction to achieve control objectives. The details about short, medium and long term process control strategy should be clearly spelled out. For example in the long run, 'very damaging' category of risk should be completely eliminated. Or the company may specify residual risks (i.e. risks that remain after controls have been implemented) to be set at 30 per cent, 20 per cent and 10 per cent for short term, medium term and long term scenarios. Companies that plan and chart overall process control direction have reached level 2 of the internal control maturity model.

Companies should design overall internal control policies and procedures that demonstrate a company's commitment to internal control. Companies must design a sophisticated process control environment that encourages open communication which relates to process weakness. For example, to create a feedback forum or even regular workshops to inform about key changes in the internal control policies and procedures. Companies that lack sophisticated control environment have not yet reached level 3 of the internal control maturity model.

Companies must embrace process control management tools and techniques that allow for detection of anomalies from the desired state of control. For example, conduct internal control assessment (control matrix), conduct periodic control audits, engage forensic specialists, and implement a fraud/bribery hotline. Rigorous detection of control flaws is the hallmark of level 4 organisations. Companies that do not employ rigorous control techniques have not yet reached level 4 of the internal control maturity model.

Companies must improve overall control conscious by placing a value on self-evaluation and developing mechanisms to encourage self-reflection. Experiential-based learning needs to be encouraged and facilitated so as to ensure learning from past experiences takes place. Only in this way will companies be able to learn from past experiences and prevent potential cases of control oversight from occurring. Companies that have not diligently improved control conscious and embraced honest self-evaluations have not reached level 5 of the internal control maturity model.

Based on the above internal control maturity assessment, companies may have a better understanding of their level of control maturity. Besides the control maturity level, companies may examine the level of preparedness in minimising risks and control mechanisms that are missing in their financial reporting processes.

Conclusion

Corporate scandals such as Enron, WorldCom and Satyam have drawn significant attention to financial reporting risks. This has implications for public interest as the prevalence and consequences of weak internal control over financial reporting may affect the confidence of shareholders, creditors and the public in the financial system. It is vital for companies to embrace corporate governance to adopt a positive mindset and learn the best governance practices. They must invest considerable effort in crafting corporate governance culture and approach that promotes accountability and effective internal control over financial reporting. It is an important pre-requisite condition when engaging external stakeholders such as potential investors, creditors and customers. In the long run, it may even serve as a foundation for continued enterprise growth and profitability.

References and further reading

- Corporate Governance Council of Singapore (2012a), "Risk Governance Guidance for Listed Boards." [URL](#)
- Corporate Governance Council of Singapore (2012b), "Revised Code of Corporate Governance 2012" [URL](#)
- CPA Australia (2008), "Internal Controls for Small Business" [URL](#)
- Goh, BW and Kim, JB (2013), "Internal Control and Operational Efficiency" Available at SSRN [URL](#)
- Hoitash, U, Hoitash, R and Bedard, JC (2009), "Corporate Governance and Internal Control over Financial Reporting: A Comparison of Regulatory Regimes." *The Accounting Review* 84 (3), pp. 839-867 [URL](#)
- Singapore Exchange (2012), "SGX-ST Listing Manual" [URL](#)

Chapter 5

Understanding Audit and Assurance

CPA Australia¹

Introduction

Auditing and assurance play an essential role in the effective operation of our capital markets and the economy at large, providing confidence to current and prospective shareholders about the information disclosed by companies. A guide to understanding auditing and assurance should assist managers who are not experts in auditing and assurance to better understand the messages from their company's auditor and improve the quality of financial statements.

Why are audits and reviews required?

Shareholders are often quite separate from those managing and governing the companies they own. They need a reliable source of financial information on which to assess the company and the performance of management. The same can be said for other stakeholders of companies, such as creditors, lenders, employees, analysts, prospective shareholders, governments and communities. Audits and reviews enhance the credibility of the information contained within the financial statements so that shareholders and other stakeholders can make assessments and decisions with confidence and on a consistent basis.

¹This article was adapted by Wang Jiwei based on CPA Australia's publication titled "A Guide to Understanding Auditing and Assurance".

What does assurance mean?

The term assurance refers to the expression of a conclusion that is intended to increase the confidence that users can place in a given subject matter or information. For example, an auditor's report is a conclusion that increases the confidence that users can place in a company's financial statements. The assurance enhances the credibility of financial information and hence reduces the cost of raising capital (see Chapter 1 on the *Ecosystem for Achieving High Quality Financial Information*). There are different levels of assurance, which depend on the type of work that the assurance practitioner performs, and these different levels also lead to different types of conclusions. Exhibit 5.1 provides a summary of different types of assurance.

Type of assurance	For example	Nature of key work performed	Example form of conclusion
Reasonable Assurance	An audit of financial statements	Detailed testing, evidence gathering and substantiation to support the conclusion.	"We believe the financial statements present a true and fair view".
Limited Assurance	A review of financial statements	Primarily enquiries and analysis, detailed procedures.	"We have not become aware of any matter to cause us to believe the financial statements do not present a true and fair view".
No Assurance	Preparing financial statements (compilation)	Preparation of the statements	No conclusion provided

Exhibit 5.1: Types of assurance

What is an audit of financial statements?

An audit of financial statements is a reasonable assurance engagement where the auditor provides an opinion about whether the financial statements present a true and fair view and are in accordance with accounting standards (and legislation where appropriate).

The full-year financial statements of Singapore-listed companies are required by law to be audited. Many other types of entities are also required to have their financial statements audited, such as non-listed companies over a certain size threshold, some charities and not-for-profit entities. Audit exemption in Singapore is governed by Sections 205A, 205B, 205C and 205D of the Companies Act.

While the reasonable assurance obtained in an audit is a high level of assurance, it is not absolute assurance (a certification that the financial statements are completely correct). Obtaining absolute assurance is not possible in financial statement audits for a number of reasons, including:

- It would be impractical for the auditor to test and audit every transaction.
- Financial statements involve judgements and estimates which often cannot be determined exactly and may be contingent on future events.

What is a review of financial statements?

A review of financial statements is a limited assurance engagement where the reviewer provides a conclusion to the users of the financial statements as to whether they present a true and fair view and are in accordance with accounting standards.

The half-year reports and/or quarterly reports of Singapore-listed companies are not required to be audited but are expected to be reviewed by the same auditor that will audit the financial statements at the end of the year.

Relationships in financial reporting

The following exhibit shows the relationship between shareholders and other stakeholders, management and the auditor or reviewer.

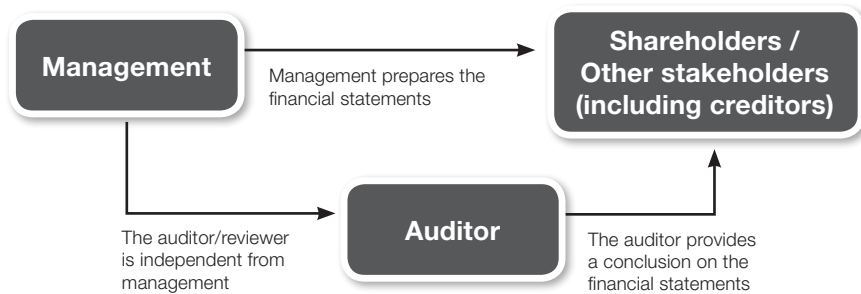


Exhibit 5.2: Relationships in financial reporting

In listed companies, a sub-committee of the board of directors called the audit committee usually arranges the appointment of the auditor. The audit committee typically meets with the auditor throughout the year to discuss details such as scheduling, risks, financial reporting issues, the auditor's findings and other matters relevant to the audit and financial statements. At the conclusion of the audit, the auditor often provides a more detailed confidential report to the audit committee.

In Singapore, auditors may attend a listed company's Annual General Meeting and be available to answer questions from interested parties that are entitled to participate in the meeting, such as shareholders. This is a useful opportunity to clarify specific aspects of the audit.

The auditor's report

The auditor's report contains the auditor's opinion on the financial statements in addition to a range of other information. An unmodified auditor's report effectively states that the auditor believes the financial statements present a true and fair view and are in accordance with accounting standards and

relevant legislation. This is sometimes also called an "unqualified" or a "clean" audit opinion. Unmodified auditor's reports are the most common type you are likely to come across. This is in part because management usually addresses most of the problems or adjustments that auditors discover before the financial statements are issued.

An unmodified review report effectively states the reviewer did not become aware of anything that suggested the financial statements do not present a true and fair view in accordance with accounting standards.

Emphasis of matter and other paragraphs

In some circumstances, the auditor will include additional wording in the auditor's report directing users to information that, in their view, is fundamental to understanding the financial statements. This may be information included in the financial statements, such as a note (called an "emphasis of matter" paragraph), or information that is included elsewhere (called an "other matter paragraph"). It is important to note that an emphasis of matter or other matter paragraph is not a qualification, limitation or adverse conclusion (for various types of auditor's reports, see Modified auditor's reports below). Exhibit 5.3 gives some examples of additional wording in the auditor's report.

Type of paragraph	Examples
Emphasis of matter	<ul style="list-style-type: none"> There is a significant uncertainty as to the company's ability to continue as a going concern, which has been appropriately disclosed in the financial statements. The financial statements are not prepared on the basis of applying all accounting standards.
Other matter	<ul style="list-style-type: none"> There is information included in an annual report that is inconsistent with the audited financial statements (for example, the figures in the operating review are inconsistent with those disclosed in the financial statements).

Exhibit 5.3: Types of additional wording in auditor's report

Modified auditor's reports

Modified auditor's reports are issued when the auditor believes the financial statements contain a material misstatement or when the auditor is unable to obtain enough evidence to form an opinion. Exhibit 5.4 sets out the different types of modified auditor's reports that may be issued in these situations.

Type of modified audit opinion	Description	Situations where this type of report may be issued	Examples
Qualified or "except for" opinion	The opinion states the financial statements present a true and fair view, and are in accordance with accounting standards except for the effect of a specific matter or matters. The issues are described in a separate paragraph within the report.	A qualified opinion is issued when a specific part of the financial statements contains a material misstatement (or inadequate evidence in a specific, material area), and the rest of the financial statements are found to present a true and fair view, in accordance with accounting standards.	The auditor has a different view on the valuation of an asset than that applied by management in the financial statements, but the rest of the financial statements are found to be free of material misstatements.
Disclaimer of opinion	The auditor cannot reach an opinion overall on the financial statements and therefore disclaims any opinion on it.	A disclaimer of opinion is issued when the auditor cannot obtain adequate evidence to form an opinion on the financial statements overall.	The company's financial reporting information system is damaged and key data is lost, meaning adequate evidence is not available to support the disclosures in the financial statements.
Adverse opinion	The opinion states that the auditor believes the financial statements do not present a true and fair view and are not in accordance with accounting standards.	An adverse opinion is issued when the auditor believes misstatements are so pervasive that the financial statements do not present a true and fair view or are not in accordance with accounting standards.	The auditor believes that management has applied an inappropriate financial reporting framework in preparing the financial statements.

Exhibit 5.4: Types of modified audit reports

How can you tell if the auditor's report is clean or not?

To determine if an auditor's report is clean or modified, you need to look at the "opinion" section. This is usually found towards the end of the auditor's report before the auditor's name and signature. An unqualified or clean audit opinion will state that the auditor believes the financial statements present a true and fair view and are in accordance with accounting standards and relevant legislation. A modified auditor's report will contain a qualification to that statement, a disclaimer or an adverse statement (see also "Modified auditor's reports" earlier).

What is auditor independence?

An independent auditor is free from external influence or bias and is therefore able to independently form judgements and conclusions during the audit. Auditors are subject to professional ethical standards, including extensive requirements for auditor independence both in mind and in appearance. It is critical that auditors are not only actually independent but also seen as independent.

Many of the laws and regulations applicable to audits, such as those in the Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (issued by ACRA) and the Singapore Standard on Quality Control (SSQC) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* (issued by ICPAS), set out additional independence requirements that auditors of relevant companies need to meet. For listed companies in Singapore, some of these additional requirements include:

- The audit partner of an issuer must not be in charge of more than 5 consecutive audits for a full financial year.
- Partners and staff to complete an annual personal independence confirmation.

What do auditors and reviewers do?

The audit or review of financial statements is a systematic process designed to identify instances of material misstatement in the financial statements. Extensive auditing and assurance standards and legislative requirements set the framework and minimum requirements for financial statement audits and reviews. Exhibit 5.5 illustrates at a very high level what is involved in financial statement audits and reviews, and the order in which activities usually take place during the year:

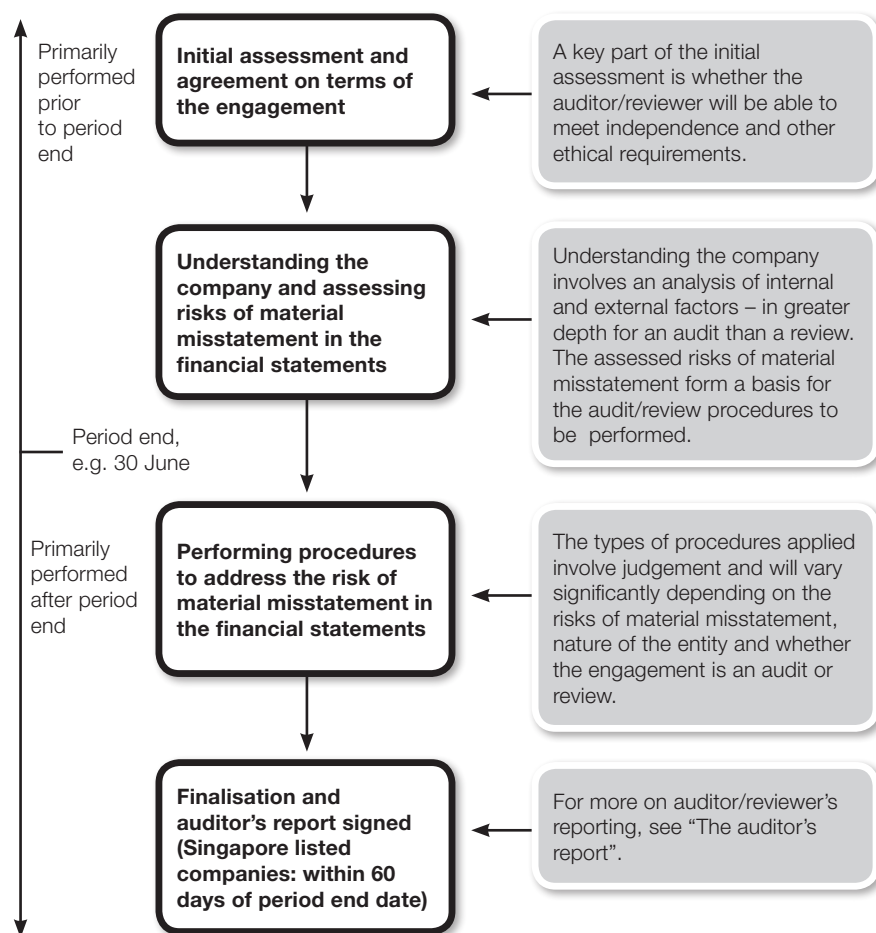


Exhibit 5.5: Audit and review process

What does materiality mean?

As mentioned above, auditors and reviewers are concerned with material misstatements, rather than any misstatement in the financial statements. Material misstatements are those that are significant enough to affect the decisions made by the users of the financial statements. This can be in terms of the quantitative or qualitative significance of misstatements. Exhibit 5.6 presents some examples of quantitative and qualitative significance of misstatements

Quantitative	The quantities or dollar amounts in the financial statements. For example, quantitatively material misstatements could include: <ul style="list-style-type: none"> • Overstating revenue • Missing/not recorded liabilities • Understating expenses
Qualitative	The nature of items in the financial statements. For example, qualitatively material misstatements could include: <ul style="list-style-type: none"> • Not disclosing certain related party transactions • Not disclosing management's remuneration <p>These disclosures are important in evaluating how the company has been managed, although they may be small quantitatively in comparison to the scale of the company's overall operations.</p>

Exhibit 5.6: Quantitative and qualitative significance of misstatements

What do auditors do in regard to fraud?

Auditors consider the possibility that fraudulent activities can result in material misstatement in the financial statements and take this into account in planning and performing their work. Fraud is defined in auditing and assurance standards as an "intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage".

An audit is not an investigation intended to uncover all instances of fraud. However, it is reasonable to expect that an audit would detect instances of fraud that result in material misstatement.

What do auditors do in regard to going concern?

The going concern assumption is that a company will continue in business for the foreseeable future. This assumption is adopted unless evidence indicates otherwise.

The going concern assumption has a significant impact on how a company's financial statements are presented. Companies that are not a going concern report on a different basis from those that are – for example, assets and liabilities would be recognised at their immediate sale value/liquidation value rather than their value in future use.

In preparing the financial statements, management makes an assumption as to whether it believes the company will be able to continue as a going concern. The auditor performs work to assess this assumption as part of the audit.

The work of the auditor includes:

- Obtaining evidence that can be used to assess the appropriateness of management's assumptions in regard to going concern.
- Forming a conclusion on whether that evidence indicates any material uncertainties in the ability of the company to continue as a going concern.

Sample items required by auditors before commencing an audit:

- Draft financial statements with supporting schedules for each account
- Minutes of shareholders' and directors' meetings
- Copies of agreements entered during the year
- Inter-company and related-party balances/transactions
- Internal control policies

The auditor's focus in this assessment is whether the company can continue as a going concern for a 12-month period from the date of signing the auditor's report.

The going concern assumption involves judgements about events taking place in the future, which are inherently uncertain. Where there is significant uncertainty in the company's ability to continue as a going concern and this has been disclosed by management in the financial statements, the auditor includes wording in the auditor's report to direct users to the applicable note in the financial statements. This is called an emphasis of matter paragraph. If the auditor ultimately does not agree with management's assumptions in regard to going concern, the result would be a modified opinion (see "The auditor's report").

Does a clean auditor's report mean a clean bill of health for the company?

Auditor's reports are intended to increase the degree of confidence users have in the information in financial statements – not about the state of the company itself or whether it is a safe investment. An unmodified auditor's report means investors or other stakeholders can make an assessment of the company based on its financial statements, with a higher degree of confidence that the information is materially correct and unbiased.

Auditors do perform a role in assessing the appropriateness of the going concern assumptions used by management in preparing the financial statements but this cannot be taken as a conclusion on the solvency or financial health of the company (see "What do auditors do in regard to going concern?").

Does the auditor sign off on the whole annual report?

The auditor's report is about the financial statements, which are usually included in the annual report. Other information within the annual report may not have been subjected to assurance (for example, management discussion and analysis or an operating review). However, the auditor does consider whether this accompanying information is consistent with the audited financial statements. So, for example, the auditor would report if the profit results included in the operating review were inconsistent with those in the financial statements.

Difference between internal and external audit

Internal audit is an appraisal activity established within an entity and functions under the direction of the company's management and board. It is a management tool and forms part of the company's internal control structure.

In general, the main focus of an internal audit is to evaluate the adequacy and effectiveness of the company's internal control. Conversely, an external audit is undertaken by an auditor who is independent from the entity and has been appointed to express an opinion on the financial statements or other specified accountability matter. External auditors act and report in accordance with their mandates, which may be dictated by legislation, regulation or established in a contract.

Other assurance

Assurance is also applicable in a wide and expanding range of other areas aside from financial statements. Some examples include:

- compliance with regulations
- sustainability reports
- prospectuses

A wide group of stakeholders increasingly needs credible information in regard to the performance and impact of companies in these areas.

Conclusion

A good understanding of auditing and assurance will help managers to prepare financial reports more efficiently. An audited financial report will give credibility to the information and hence increase the usefulness of financial reporting. Managers, especially those who are not familiar with the auditing and assurance process, are encouraged to gain some basic understanding of auditing and assurance.

References and further reading

CPA Australia (2013), "A Guide to Understanding Auditing and Assurance"

[URL](#)

ICPAS (undated), "Singapore Standards on Auditing" [URL](#)

ICPAS and ICAA (2010), "The Benefit of Audit" [URL](#)

Chapter 6

The Financial Close – Adding Value to Your Business

Foo Kon Tan Grant Thornton LLP

Introduction

The financial close is an important element in the preparation of financial statements. Some financial close processes work efficiently and effectively, and others simply do not. Identifying the value that an effective close can bring to a company is one of the first steps to making a successful change to the current process. By understanding one's own process flow and the factors that may identify inefficiencies, a company can begin to monitor and benchmark its own internal key performance indicators. An effective close implementation can not only cut down on the closing timing but also can enhance performance, increase control over finance activities, and add value to the business.

What is a financial close?

The financial close is the accounting process from the month-end to the point when the internal and external financial reports are produced and available for use and management reporting is complete. Financial close activities include the time required to post system and manual entries into the general ledger, to prepare the consolidated financial statements and to prepare eliminations. It normally does not include the preparation or the filing for regulatory purposes,

or any budgeting or forecasting activities. The financial close is fundamentally a summary of all transactional activity of a business that takes place in a specific reporting period. In most cases, the reporting period is a month or sometimes a quarter.

Most organisations have their own unique financial close process and policies. However, the ability to identify and assess some of the key drivers and common issues can lead to a much more effective and value added financial close process. A financial close that is effective offers better timeliness, quality, reliability and transparency. This results in several benefits to a company including:

Enhanced performance

- Reduces time to close the books each period, offering more time to assess the results
- Improves quality, accuracy and timeliness of financial information
- Increases capability to make financial decisions with reliable data
- Eliminates unnecessary activities

Increased control over finance activities

- Helps the company focus on goals and objectives rather than on processes
- Reduces number of manual entries
- Integrates databases between applications
- Reduces errors
- Establishes policies and processes that should be consistently followed

Value-added to the business

- Lowers cost of accounting and finance function based on reducing personnel time
- Improves productivity: staff time freed to engage in more strategic services such as benchmarking, forecasting or giving input into financial decisions
- Gives greater investor confidence because financial statements are more timely and accurate. Reduces accounting errors and potential misstatements, which in turn reduces audit fees
- Improves information technology systems and applications that do not interface

An effective versus an ineffective financial close

There are many noticeable differences between an effective and an ineffective close. Some are more apparent than others, but management should determine which side of the line they fall on when it comes to their own close process. The following table shows some common differences.

Effective Financial Close	Ineffective Financial Close
Processes documented and defined	No documentation and poorly defined
Repeatable	Inconsistent
Automated	Labour intensive
Integrated systems	Multiple systems, no integration
Standardised, templates, journals, and policies	Hotchpotch of documents
Clear roles and responsibilities	No user input or segregation of tasks
Company-wide involvement	Key finance personnel only
"Do it once, do it right" approach	Multiple errors or adjustments
Timely close	Close drags on past acceptable time

Exhibit 6.1: Effective versus ineffective financial close

An ineffective close can be caused by many factors. One common factor in some financial closes is on simply supplying transaction data. The problem is that individuals or business units are not part of the planning process; they do not always have clear responsibilities for owning or supplying data or understanding what that data is used for. Also, there could be multiple systems and limited interfaces, awkward email data transmittal and poor alignment between finance and the other divisions. In an effective financial close, there is a planning focus rather than a transaction focus. The role of technology is enhanced and better coordinated. In a well-run financial close, the company employs integrated systems and automated data transmittal. It allows companies to close their books more accurately, efficiently and quickly — thereby meeting shareholder, regulatory or auditor requirements, as well as market or executive management demands to provide more timely information.

C-Suite or executive sponsorship is a key prerequisite to implementing an effective company-wide financial close process. Executive support establishes the importance of having an effective financial close throughout the organisation. Executive sponsorship also communicates to the organisation that the financial close process is not limited to finance and accounting.

An effective financial close spans the organisation because data usually rolls up from divisional, local, regional or international operations. All company processes are linked to the financial close. It is important they understand the need to have a high degree of communication with people in the field so they can collaborate and become part of the change. Employees company-wide must understand the re-direction of their goals, as it moves from being process-oriented to focusing on the setting of time-sensitive objectives. The financial information resulting from an effective financial close can help executives, at both the operational and senior executive levels, to make more timely and informed business decisions based on financial data. Finance therefore becomes less of a “scorekeeper” and more of a business partner with the rest of the company.

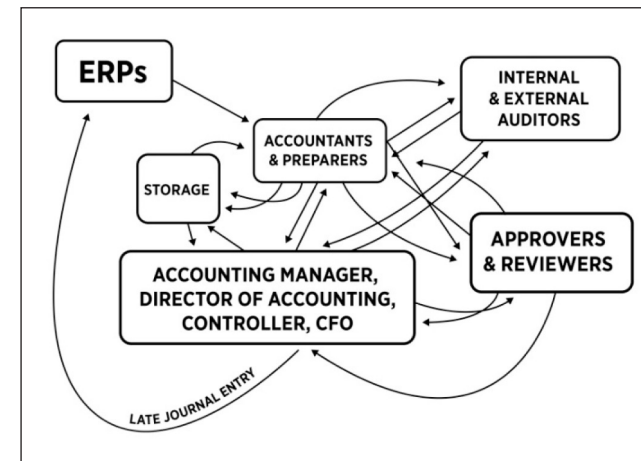


Exhibit 6.2: An ineffective financial close process (Blackline Systems Inc. ©)

As illustrated in Exhibit 6.2, the financial close involves many players, and without a clearly defined process, the flow can become very tangled and unorganised. Instead of being solely the responsibility of a company’s finance function, an effective financial close is a top-down, company-wide activity. There needs to be a clear process flow, with a sufficient understanding of how each user, system, or process works in tandem, with regular contact with each participant, including operational personnel, in the financial close process. Data flow between systems and various users must be understood and should be reviewed and documented, to avoid duplication or redundancies in the flow of information. Otherwise, the close will look more like the tangled web above, as opposed to a streamlined process.

Key phases towards an effective financial close process

Once management has determined that there is a need to make changes to the close process, careful consideration should be given to the various phases involved in that process. The evaluation of the company’s own process along with developing and then implementing a plan each has unique considerations for management.

Phase 1: *Evaluate the current process flow and identify performance gaps (from both an effectiveness and efficiency perspective)*

The first phase in the process is to evaluate current process flow and identify performance inefficiencies. The goal of this phase is to identify performance gaps, bottlenecks or inefficiencies, possible changes in job descriptions and clarify reporting responsibilities. When analysing and assessing the current close process to determine if changes should be made, there are many indicators that management should consider, which can include:

Implementing an effective financial close:

- Evaluate current process flow and identify performance gaps
- Develop a plan to monitor and reduce inefficiencies
- Implement plan

High number of transactions

- If a company has a large number of manual journal entries or handoffs, there is a potential benefit to the company if these transactions are automated or eliminated.

Time-consuming error correction and problem solving

- When there is a large number of processes within the close cycle that require an individual's time to clear (e.g. suspense accounts or error correction related to reconciliation activities or other types of manual activities), this indicates inherent inefficiencies in the financial close process.

Undefined processes

- The absence of a clear timetable or timeline driving the organisation.
- No clear ending to the process.
- Blending the development of management reporting with the financial close process.

- Inefficiency in reporting to management or the Board with timely information.
- Restatements, either from error corrections or problem-solving.

Duplication of effort

- Office audits: documents flow from one person to the next or one system to the next, and checkpoints are added by management to audit the numbers. In many cases, these in-process audits are duplications of what has already happened.
- Multiple systems of record: islands of information with similar data that are not flowing through the system. As these data flows impact the General Ledger, there is duplication in how the reports are printed, reviewed and then manually keyed into yet another system that feeds into the General Ledger.

High number of hand-offs

- Manual hand-offs, where multiple individuals involved in the closing process complete one step in a long sequence.
- Information technology-related processing hand-offs where there are disparate systems. For example, the company might use Hyperion or some type of financial consolidation package that sits on top of an ERP system, along with clusters of legacy systems and interfaces making sure the data gets transferred over correctly.

High transaction processing costs

- Transaction costs can result from the time incurred to complete a reconciliation, process a journal entry, clear a suspense account, or any other costs incurred by using the company's systems to complete the financial close process. Each company's cost-per transaction must be looked at separately.

Inaccurate and unreliable financial forecasts and reporting

- The more accurate the financial close process, the better the company will be in preparing volume estimates and preparing current and quarterly forecasts. The more accurate the financial close numbers, the better the forecasts will be.

Lack of balanced-scorecard metrics as a basis for decision-making

- This indicator demonstrates that the financial close process is more than just a finance activity. It shows the impact of other users of the financial data. The financial close data is an input into calculating key performance indicators and developing balanced scorecards.

Lack of ability to report financial events immediately

- Reporting financial events quickly is critical in the view of most CEOs and CFOs, in order to be able to get immediate information on material events, including fraud and misstatements.

Reliance on multiple systems that do not interface

- If the company runs disparate systems or runs different ERPs or accounting systems across the organisation, then it is faced with problems or issues that surround the consolidating of those different systems. If the systems are not integrated, then part of the financial close tends to be a manual function.
- If the company runs manual systems that are neither automated nor integrated, watch out for multiple non-standardised templates, journals, instructions and policies.

Excessive overtime

- If the finance department puts in long hours executing the financial close (whether through overtime or temporary help), costs increase in the accounting department and can be an indicator of need.

These indicators are just some of the more common items found in various companies. However, as part of the analysis of the current process, management must first confirm that the company and users performing the processes understand why they are doing what they are doing. In many cases, people do things because “it is the way it has always been done.” Usually if people do not understand why they are doing something, it is an indicator that it may not be a value-added activity.

Another important step in analysing and assessing the current close process involves integrating systems and using information technology as an enabler to improve efficiencies. This step might include software system selection because the company’s software systems may not be integrated and may not consolidate information effectively. Existing technology may be capable of sufficiently meeting the company’s requirements. For example, a company’s information technology systems may have the ability to automate manual reconciliations but are not doing so. By evaluating the company’s systems and applications, the company can evaluate how to better leverage functionality, validations and reporting.

The company should be looking at roadblocks or bottlenecks that exist in the critical path. This can be a big issue in some financial close processes, especially with one-off or bolt-on systems where the close is not integrated with the financial process. For example, there might be a spreadsheet that does the fixed-asset depreciation or a special piece of software that does a specific calculation.

Phase 2: Develop a plan to monitor and reduce the inefficiencies

Developing a plan to monitor and reduce the inefficiencies first includes a benchmark analysis. This relates to understanding how management will measure success in the financial close process. Benchmarking can be achieved by identifying where processes currently stand in relation to different metrics and then conducting another assessment after the implementation of the effective financial close. The aim is to see levels of improvement. Critical paths and limiting or constraining factors that create roadblocks and bottlenecks should be identified and addressed early.

For example, one benchmark might be total person days, including overtime, spent in the financial close process. Another benchmark might be the time it takes to perform complete reconciliations, as well as the consolidation and elimination. This is especially important in the distinction between a “soft close” and a “hard close.” If the company aims for a hard close at the end of a quarter or end of the month, it needs to complete all the reconciliations, clear all the suspense accounts and eliminate all the consolidating entries. The company can create benchmarks on how long it takes to do each of these activities.

There could be several important Key Performance Indicators:

- Total cost of financial reporting per thousand dollars of revenue
- Percentage of General Ledger time spent on corrections
- Cycle time to close General Ledger
- Percent profit forecast variation
- Cycle time for annual budget preparation
- Total cost of management reporting per thousand dollars of revenue
- Cycle time for senior management to get reports
- Total cost of budget process per thousand dollars of revenue.

It is important to understand what the company’s financial close process looks like in terms of cycle time. As a starting point consider: When does the company close the General Ledger? Are consolidation entries used to correct errors in business units? How do the company’s standards compare with leading indicators and comparable numbers seen in the industry? As benchmark goals are established, make sure the goals are attainable. Both professionals and companies sometimes set unrealistic goals. To go from ten days to six days may be attainable. To go from ten to two may involve a cost factor (in technology, people or process) that the company may be unwilling to pay.

Reducing the close cycle time is a two-step process. As an initial step, the company might be able to save time by making process improvements. Then, by further enhancing the environment with information technology solutions, the company might be able to further improve the financial close. Benchmarking means looking at these areas, seeing where the company is currently and where they need to be given their objectives and industry standards. Financial close reduction opportunities typically will fall into one of the following categories: process issues, technology issues and people issues.

Phase 3: Implement the plan to improve the financial close process

The final phase involves the actual implementation of the plan based on the evaluation and findings noted in phases 1 and 2. Once again, this phase needs participation from various members of the company to be successful. Some common considerations include:

Change Management

Implementing an effective financial closing process will be a cultural change for the financial or accounting organisation. It is important to ensure that everyone understands what his or her new roles and responsibilities will be. Change management should be part of early conversations amongst management because it will be an ongoing process. In addition to managing the behavioural aspects of change, the company needs a way to measure success. In some organisations, changing the financial close process might be a significant initiative. The company needs benchmarks of success.

The people involved need to be part of the development of the new processes so that they have a personal interest in the change. Also, there needs to be ongoing reinforcement that these are new processes to be adhered to and not just a “project”. Sometimes the company may overlook the importance of helping people understand what their new roles and responsibilities will be. The advantages of the new processes to individuals, as well as to the company, need to be clearly communicated.

Designing a Financial Close Calendar and Creating Standard Journal Entry Checklists

The financial close calendar is the standard that drives activities. The aim is to ensure that everyone understands the deadlines. If it is possible, the process should be tracked automatically so the controller can see where the close process stands at any given point in time. Designing a close calendar and standard journal entry checklists establishes objectives for the company. It should be like a well-run assembly line. The risk is that specific processes slide from taking one day to taking two or three days. If one item is allowed to shift, it may shift everything.

Designing Close Policies and Procedures

Policies are general guidelines. Procedures are systematic approaches that the company will follow. There may be a need for multiple policies at different levels. The more succinct and concise the policies are, the less likely it is for interpretation issues to arise. Policies and procedures can be used as training tools. With policy changes, roles and responsibilities will also change. Defining the roles and responsibilities and assigning each activity within the close process to specific individuals needs to be carefully addressed.

Identifying Flash Reporting Requirements

Flash reporting requirements cover summary-level financial reporting. Flash reports give financial performance highlights in advance of the close. These may include reports on revenue, cost of sales and EBITDA. It is not a full financial statement but a “flash” or interim report. If the business users or management see something that looks awry, they can call it to the accounting department’s attention before the financial close actually happens. Typically, flash reports occur both midmonth and immediately before the close. If there is a large error, it will show up in the flash report measures.

Designing Future-state Performance Targets and Indicators

When reporting and recommending, the company needs to make certain that the key performance indicators identified in the earlier phase actually happen and those responsible are held accountable. As the organisation gets more experience with the new financial closing process, it should be viewed as a continuous improvement process. The company may not be ready for certain aspects yet because the process is not mature enough but it can identify targets for the future.

Conclusion

Whether your business is large or small, there can be value found in an effective financial close. It takes a top-down and company-wide approach to make a positive change. This starts by getting those involved to “buy-in” to the change and the importance of the process flow, as well as everyone’s role and responsibility within. Asking yourself what is broken and how to fix it can seem complicated. However, a company can perform the key phases by first evaluating the current process flow and identifying performance inefficiencies. Next, the company should develop a plan to monitor and reduce the gaps. Finally, the company can look towards implementing the plan to improve the financial close process. These steps will enable a company to benefit from efficiencies gained and the value added from an effective financial close. It should save your organisation time and money.

References and further reading

CFO Research Services/SAP (2010), “Accelerating the Financial Close: CFOs’ Insights into the Benefits of a High-Quality Close” [URL](#)

Institute of Chartered Accountants in Australia (2011), “Business Guidance Notes: Month end reporting” [URL](#)

Chapter 7

Preparing High Quality XBRL Financial Statements

Lin Weiting, Accounting and Corporate Regulatory Authority

Introduction

Consumers and investors increasingly expect quick and convenient access to information and expect the information to be of a high standard - up to date, complete and accurate. The same applies to financial statements. Investors, creditors and businesses require reliable information to make their decisions.

Companies can meet these new expectations by filing high quality XBRL financial statements with ACRA. Stakeholders interested in the performance of your company can now easily access and analyse this data - thanks to the introduction of XBRL.

This chapter will help you understand how to submit a set of high quality XBRL financial statements under the current XBRL filing requirements, as well as the revised requirements which will come into effect from October 2013.

What is XBRL?

XBRL, or eXtensible Business Reporting Language, is a non-proprietary and global standard for exchanging business information. It is a computing language which allows information to be marked or “tagged” in a way that computers can read and process. When we use XBRL to tag information in financial statements, every number and entry in the financial statements is given a unique code (analogous to a barcode) that tells computers what the item represents (e.g. a value of S\$20 million within the financial statements is the amount of Revenue stated for FY2011) and how it relates to other items (e.g. Gross profit is the difference between Revenue and Cost of sales) in the financial statements.

Software, whether on a laptop or smart-phone, can use XBRL tags to process the information in an intelligent way, thus giving information consumers standardised information from multiple financial statements even if the statements are not presented in the same way. For example, different companies might record trade receivables in different sections of the financial statements such as in the primary financial statements or in the disclosure notes to accounts. As long as this piece of information contains the same XBRL tag, information consumers can easily compare trade receivables across companies and industries. They can even extract and compare more detailed information such as the amount of trade receivables due to third parties or related parties if the information is submitted with the necessary XBRL tags.

XBRL's ability to present standardised information instantaneously has reduced data extraction time, which previously made analysis and comparison very time consuming. Singapore now has analytical tools (such as Singapore Financials Direct) which offer business analytics using XBRL information submitted by companies to ACRA. Such tools allow companies to do cross-company analysis and industry benchmarking easily without the need to manually extract the data from financial statements.

Filing XBRL financial statements with ACRA

To create valuable information for business and investors in Singapore, all companies limited or unlimited by shares filing their financial statements with ACRA have been required to submit them in XBRL format since November 2007. Companies can choose to file their XBRL financial statements in either Option A – Full XBRL or Option B – Partial XBRL to ACRA. Preparers can currently use FS Manager, an online financial statements preparation tool, to prepare and submit their financial statements in XBRL format to ACRA.

As the next phase of XBRL filing in Singapore, ACRA is revising the XBRL filing requirements. From October 2013, all companies limited or unlimited by shares filing their financial statements with ACRA will be required to submit a full set of financial statements in XBRL. As part of ACRA's approach to collect XBRL information from companies without creating an excessive burden, ACRA is introducing a new “*Minimum Requirements List*”. Companies will only need to submit information required under the *Minimum Requirements List* if the information is in their financial statements. ACRA will make available an offline BizFin^x preparation tool at no charge to allow companies to prepare a set of financial statements in accordance with the revised XBRL filing requirements.

Current XBRL filing requirements until Oct 2013	Revised XBRL filing requirements from Oct 2013
<ul style="list-style-type: none"> Filing options - Option A (Full XBRL) or Option B (Partial XBRL) Submit to ACRA via FS Manager 	<ul style="list-style-type: none"> Full set of financial statements in XBRL Submit to ACRA via BizFin^x Portal

Exhibit 7.1: XBRL filing requirements (before and after October 2013)

How to prepare correct XBRL financial statements

There are three ingredients to prepare a set of correct XBRL financial statements:

- preparation of the XBRL financial statements by preparers who are trained in accounting, preparation of financial statements and ACRA's XBRL filing requirements (whether internal staff or external help)
- a validation process in ACRA's system which will identify errors that the company needs to correct and highlight possible errors that the company may need to review
- a review process within the company to assist directors with their responsibilities

These steps are explained in more detail below.

Equipped with the necessary know-how

Good accounting and financial reporting depends on having preparers with the right training and this is no different with the introduction of XBRL. While there are XBRL tools available to facilitate filing, companies still need preparers, whether trained staff or external accountants, who know the accounting standards and how to prepare financial statements. Under the revised XBRL filing requirements, this knowledge is particularly important as information from different parts of the financial statements is required to be submitted under their respective templates as part of the *Minimum Requirements List*. Proper understanding of these templates would also facilitate proper submission of information.

Validation rules for XBRL financial statements

Before submission to ACRA, all XBRL financial statements need to be validated against a set of business rules that are maintained in the XBRL system. This validation performs checks and gives companies two kinds of feedback:

- Genuine errors – These are errors that you must rectify before you file. In cases where the issue identified is an exception and not an error, you can apply for exemption from specific XBRL filing requirements.
- Possible errors – These are warnings of possibly incorrect XBRL data. If your XBRL data contains an error, you need to rectify the error. If the XBRL data is correct (i.e. no error), you may ignore the warning.

ACRA's business rules can only check information submitted to a certain extent and are not a guarantee of accuracy. For example, the rules are unable to determine whether the level of rounding used within the financial statements is correct or not. As such, preparers still need to properly review the XBRL financial statements to ensure that they are accurate and complete.

Proper review process

As it is ultimately the directors' responsibility to ensure that their company's XBRL information is correct, a company should have a proper review process for XBRL financial statements.

Understanding common errors

If you know the common XBRL filing errors they should be easy to avoid, thus saving you time and trouble when preparing and reviewing your XBRL financial statements. ACRA has identified common errors in XBRL financial statements since it was implemented in 2007, which are relevant to both the current and revised XBRL filing requirements, unless otherwise stated. These errors can broadly be categorised into two groups:

- Submission of inaccurate data (Errors 1-5)
- Submission of incomplete data (Errors 6-7)

Note: “AGM financial statements” means the financial statements tabled at the Annual General Meeting (AGM), or, for any private company that does not hold an AGM, the financial statements sent to the shareholders of the company.

Errors Resulting in Inaccurate Data

Error 1: Incorrect level of rounding

Companies may select the incorrect level of rounding. For example some companies have selected “thousand” or ‘000 as their level of rounding used when it is not the case. As a result, the eventual information submitted to ACRA is incorrectly scaled up/down when they should not have been.

Common XBRL filing errors:

- Incorrect level of rounding
- Incorrect selection of currency
- Incorrect selection of presentation formats
- Incorrect mapping of data
- Not updating dynamic company information
- Submission of incomplete XBRL financial statements
- Non-submission of information required within the Minimum Requirements List

The level of rounding used in XBRL financial statements should be the same as that used in the Annual General Meeting (AGM) financial statements. The level of rounding is often displayed as the column headers within Income statement and Statement of Financial Position.

Error 2: Incorrect selection of currency

Selecting the incorrect presentation currency within the XBRL financial statements is a common error. For example, selection of USD when the correct currency is SGD.

The presentation currency selection in XBRL financial statements should be the same as that used in AGM financial statements. The presentation currency does not refer to the functional currency used by the company, though sometimes they can be the same. The presentation currency is often displayed as the column headers within Income statement and Statement of Financial Position.

Error 3: Incorrect selection of the presentation format for Income Statement, Statement of Financial Position and Statement of Cash Flows

The accounting standards allow companies to present their Income Statement, Statement of Financial Position and Statement of Cash Flows in different presentation formats. For example, the option of presenting Income Statement using “By nature” or “By function” format.

Companies have sometimes selected the incorrect presentation format in the XBRL financial statements as compared to their AGM financial statements. Such errors will cause such statements to be disclosed with incorrect data elements, making it impossible to compare information submitted by other companies preparing in the same format. FRS 1 sets the overall requirements for the presentation of financial statements. Companies can refer to this standard for guidance and samples of presentation formats so that they can select the correct presentation formats in their XBRL financial statements.

Error 4: Incorrect mapping of data

Preparers have to submit information from their AGM financial statements using the appropriate elements within the XBRL financial statements. This is a process called mapping. Sometimes, mapping of information is not done correctly by companies. For example, the amount of trade and other receivables within their AGM financial statements is incorrectly submitted using *Cash and bank balances* element within the Statement of financial position when they should use the *Trade and other receivables* element.

A related common error is for preparers to use “Others” items for convenience, such as *Other financial assets* and *Other income*, for values within their AGM financial statements, when the taxonomy has more relevant elements that the company can use. For example, it would be incorrect to submit the amount of provisions using the *Other financial liabilities* element, instead of the *Provision* element within the statement of financial position. It is important not to use “Others” items inappropriately because it makes data incomparable and prevents analysis of aggregate data.

Preparers will need to exercise their judgment in mapping the information within their financial statements to the appropriate elements. This may require accounting knowledge to understand that different terms may refer to the same line item and they should be mapped together appropriately. Preparers should not use “Others” items unless there is no related taxonomy element. In addition, where the relevant taxonomy elements might be more granular or more aggregated than the item in the AGM financial statements, a best fit principle should be applied to the most appropriate element.

Error 5: Not updating dynamic company information

A common error is for preparers to not update basic information about the company that has changed since the previous year, i.e. they assume that the information has not changed since the previous filing. Some examples of such information are:

- signing auditor
- year of appointment of signing auditor
- signing director
- whether the number of employees is more than 50
- whether the company is listed as of current period year end

Preparers using the prior period XBRL file as a reference should ensure that the data is updated for current period XBRL filing.

Errors Resulting in Incomplete Data*Error 6: Submission of incomplete XBRL financial statements*

Some companies that are required to submit a full set of financial statements in XBRL format have left out certain sections of their financial statements. To fulfill the Companies Act requirements, such companies need to file a full set of financial statements unless they are exempted. As such, preparers should submit all sections of their financial statements (directors’ report, statement by directors, auditors’ report, primary financial statements and all disclosure notes). Under the revised XBRL filing requirements, the entire set of financial statements should be submitted in textual format using the *Disclosure of complete set of financial statements* element.

Error 7: Non-submission of information required within the Minimum Requirements List (Only applicable under revised XBRL filing requirements)

Preparers of XBRL financial statements need to have a good understanding of the company's AGM financial statements. The *Minimum Requirements List* within the revised XBRL filing requirements states that information required within this list should only be submitted if it is present within the AGM financial statements. Preparers may miss out on submitting necessary data if they do not have a proper understanding of the company's AGM financial statements. For example, preparers might leave out information required from the disclosure note for *Provision* (included within *Minimum Requirements List*) if they do not know that the disclosure note is present within the AGM financial statements.

To avoid this error, preparers will need to understand the information required within the *Minimum Requirements List* and their own AGM financial statements so that they can correctly identify the complete information to be submitted.

Guides and resources

To help companies comply with the revised XBRL filing requirements, ACRA will publish several help guides and resources at our webpage **www.acra.gov.sg/xbrl**. You may refer to these guides for additional guidance or assistance to prepare a set of high quality XBRL financial statements. They include the following:

- a. **Training:** ACRA will organise several training seminars for preparers to better understand the revised XBRL filing requirements. We will also work with our training partners to ensure adequate training courses are available in the market.

- b. **Dictionary of Synonyms:** The Dictionary of Synonyms contains a list of suggested synonyms for the elements within the taxonomy. This will facilitate preparers in performing accurate mapping for values within their AGM financial statements to the relevant taxonomy elements.
- c. **ACRA Taxonomy Templates:** ACRA Taxonomy Templates provide a readable representation of ACRA Taxonomy 2013 so that preparers can better understand how to submit information for the various elements.
- d. **Preparer's guide:** The Preparer's guide contains comprehensive guidance such as mapping principles to help companies prepare in accordance to the revised XBRL filing requirements to ACRA.
- e. **BizFin^x alert:** To obtain latest updates on the developments in XBRL implementation (including changes to the filing requirements, updates on common findings of errors, etc), you may want to consider signing up for the BizFin^x alert when it is launched as part of the enhanced BizFin^x filing system.

Rectifying incorrect XBRL information that has been filed

If you discover errors in your past filings, or if ACRA informs you of errors, it is the directors' responsibility to ensure that the error is corrected so that information filed is accurate. Companies and/or their directors may face prosecution if the errors are found to be materially false or misleading.

You can rectify the errors within your XBRL financial statements by filing a Notice of Error (NOE) if the error is typographical or clerical in nature. Alternatively, you can choose to rectify the errors by expunging the Annual Return which had already been filed via a court order and refiling a new Annual Return.

Conclusion

It is important for a company to file its financial statement in XBRL correctly. High quality XBRL financial statements provide reliable financial information to the company and the market to make informed decisions regarding your company. To save time and effort, companies and directors should have a robust preparation process for their XBRL financial statements. It is critical that those preparing XBRL financial statements have the right skills and knowledge, and are supported by an internal review process. Help and resources are also available from ACRA. With a concerted effort by your company, XBRL financial statements will provide valuable information to the market and increase trust and confidence in Singapore's business environment.

References and further reading

For more information on the current XBRL filing requirements, please refer to **www.acra.gov.sg/Company/Making_Changes/Preparing_and_Filing_of_Financial_Statements/**. **URL**

For more information and updates on the revised XBRL filing requirements and *Minimum Requirements List*, please refer to **www.acra.gov.sg/xbml**. **URL**

Chapter 8

A Simpler Standard for Small Entities

Wang Jiwei, Singapore Management University

Introduction

In Singapore and many other countries around the world, laws or regulations require most small and medium-sized entities (SMEs) to publish general purpose financial statements and have them audited (typically subject to an audit exemption threshold). The rationale is that stakeholders such as banks, suppliers, customers, rating agencies, venture capitalists, and outside investors all use the financial statements of SMEs to make lending, credit and investment decisions. SMEs also have incentive to provide high quality and comparable information to their stakeholders because high quality financial information will help them to reduce their cost of both debt and equity capital (see Chapter 1 on the *Ecosystem for Achieving High Quality Financial Information*).

However, compliance with the full set of International Financial Reporting Standards (IFRSs) or other equivalent national generally accepted accounting principles (GAAP) exposes significant burden on most SMEs because they have much fewer complex transactions and less complicated business models than their larger counterparts. Reporting requirements and stakeholder expectations are also different from publicly accountable enterprises such as listed companies. To reduce the accounting burden on SMEs with the full IFRSs, in July 2009, the International Accounting Standards Board (IASB) issued *IFRS for Small and Medium-sized Entities* (IFRS for SMEs). This standard provides an alternative framework that can be applied by eligible entities in place of the full IFRSs.

The IFRS for SMEs is a completely stand-alone standard and a simplified version of the full IFRSs (230 pages compared with over 3,000 pages for the full IFRSs). The simplifications are based on considerations of costs and SME capabilities as well as user needs for information about short-term cash flows, liquidity, and solvency (rather than longer-term forecasts of earnings, cash flows and share prices for larger entities). There are a number of accounting standards and disclosures that may not be relevant for the users of SME financial statements. As a result, the standard does not address topics such as earnings per share, interim financial reporting, segment reporting, and assets held for sale. Hence, it is estimated that the IFRS requires SMEs to comply with less than 10 per cent of the volume of accounting requirements applicable to listed companies complying with the full IFRSs.

In this chapter, we discuss the benefits of IFRS for SMEs, followed by a summary of major differences between the full IFRSs and IFRS for SMEs. We also discuss some major considerations prior to adopting the simplified IFRS and offer some suggestions to SMEs in Singapore.

Benefits of IFRS for SMEs

Introducing the IFRS for SMEs in July 2009, Sir David Tweedie, former chairman of IASB, said “The publication of IFRS for SMEs is a major breakthrough for companies throughout the world. For the first time, SMEs will have a common high quality and internationally respected set of accounting requirements. We believe the benefits will be felt in both developed and emerging economies.” Paul Pacter, Director of IASB Standards for SMEs, commented that “The IFRS for SMEs will provide businesses with a passport to raise capital on a national or an international basis.”

When Singapore adopted the IFRS for SMEs as Singapore Financial Reporting Standards for Small Entities (SFRS for Small Entities) in November 2010, Euleen Goh, then Chairman of the Singapore Accounting Standards Council (ASC), said: “The SFRS for Small Entities is built upon the sound principles of the full IFRSs. It is a robust standard that can stand on its own. The ASC

is of the view that the standard will better meet the needs of non-publicly accountable entities with smaller operations, and benefit them in terms of reduced financial reporting burden and more cost savings.”

In this section, we summarise the potential major benefits that the simplified IFRS may bring to SMEs.

Reducing compliance costs

The simplifications of the full IFRSs significantly reduce compliance costs for most SMEs. There are five major types of simplifications compared to the full IFRSs. We will discuss the differences in detail in the later part of this chapter.

First, the IFRS for SMEs has removed unnecessary topics (i.e. earnings per share, interim financial reporting, segment reporting, and special accounting for assets held for sale) as these are not relevant to most SMEs. Second, some accounting policy options in full IFRSs are not allowed because a more simplified method is available to SMEs. For example, IFRS for SMEs has no option to revalue property, equipment, or intangibles. Third, the IFRS for SMEs has simplified many recognition and measurement principles in full IFRSs. For example, goodwill for SMEs is considered to have a finite useful life and is amortised over this life, which is presumed to be 10 years if it cannot be determined reliably. In contrast, under IAS 36 Impairment of Assets, goodwill is not amortised and is subject to impairment test annually regardless of there being an indication of impairment. Another example is that capitalisation of borrowing cost for qualifying assets is not available under the IFRS for SMEs as all borrowing costs are to be expensed immediately. Four, there are substantially fewer disclosure requirements under IFRS for SMEs. For example, an SME is not required to present a statement of financial position as at the beginning of the earliest comparative period when the entity applies an accounting policy retrospectively or corrects a prior period error, or when it reclassifies items in its financial statements. Last, revisions to the IFRS for SMEs will be limited to once every three years.

With these simplifications, an SME is expected to comply with roughly 10 per cent of the volume of accounting requirements applicable to listed companies complying with the full set of IFRSs, which will significantly reduce SMEs' compliance costs.

Tailoring to different user needs

The intention of IASB to develop the IFRS for SMEs is to tailor a standard to the needs of the main users of financial statements. Users of SMEs' financial statements may have quite different needs from users of publicly accountable entities such as listed companies. A publicly accountable entity's financial statements are purposed to serve a wide group of users such as institutional and individual equity investors, lenders, financial analysts, credit rating agencies, government agencies, suppliers, customers, and hence the full IFRSs attempts to provide information to suit the needs of such complex users. For example, long-term equity investors of a listed company may require financial information that can help them to evaluate equity valuation from a long-term perspective. Information which can help to forecast future earnings, cash flows and share prices is vital to such investors.

In contrast, investors of SMEs in most cases would be the management and they may not demand such information for long-term valuation. Other users of SMEs' financial statements comprise much smaller user groups such as tax authorities and lenders. The IASB has taken these into consideration and has tailored the standard to the needs of these focused user groups.

Improving access to capital (and reducing the cost of capital)

Lack of transparent and comparable information disclosure is one of the biggest challenges SMEs face when they access external finance. Financiers such as banks or other financial institutions have difficulties in relying on the information provided by SMEs due to the lack of a clear and coherent

accounting principle application. The IFRS for SMEs is a globally recognised standard. When applied correctly, SMEs are expected to provide higher quality financial information in terms of reliability and comparability. It would allow financiers to better assess the company's performance and risk, enhance confidence regarding the company, and reduce barriers to access to finance. The improving access to capital will apparently result in a reduction in the cost of capital and enhance the sustainable growth of an SME.

Overall, the IFRS for SMEs is a simplified version of the full IFRSs. However there are some key differences between the IFRS for SMEs and the full IFRSs, which an SME would want to consider prior to implementing the standard.

Key differences between IFRS for SMEs and full IFRSs

As we discussed, the IFRS for SMEs was developed based on the core concepts and principles from the IASB framework and full IFRSs, with modifications to address the particular financial reporting needs of the SMEs and from a cost-benefit perspective. The simplified standard is roughly about 10 per cent of the volume of requirements under the full IFRSs. Hence there are similarities and differences between the two standards. Note, however, that IFRS for SMEs is a stand-alone standard and it is likely that differences will arise from the full IFRSs even when the principles appear to be the same or similar.

The following table compares some of the key differences between IFRS for SMEs and full IFRSs. Note that these are only highlights and not a complete overview of the requirements of the standards. The comparison is based on the requirements in the full IFRSs on issue and that are mandatorily effective for periods beginning on 1 January 2014.

IFRS for SMEs	Comparison to Full IFRSs
Presentation of financial statements	
<p>If the only changes to the equity during the period are a result of</p> <ul style="list-style-type: none"> • profit or loss, • the payment of dividends, • the correction of prior-period errors, • and/or changes in accounting policy, <p>a combined statement of income and retained earnings can be presented instead of both a statement of comprehensive income and a statement of changes in equity.</p>	<p>IAS 1 <i>Presentation of Financial Statements</i> does not include such exemption from presenting a separate statement of changes in equity.</p>
Business combinations	
<p>Transaction costs are included in the acquisition costs. Contingent considerations are included as part of the acquisition cost if it is probable that the amount will be paid and its fair value can be measured reliably.</p>	<p>Transaction costs are excluded in the acquisition costs under IFRS 3 <i>Business Combinations</i> (2008). Contingent consideration is recognised regardless of the probability of payment.</p>
Investments in associates and joint ventures	
<p>An investor may account for investments in associates or joint ventures using one of the following:</p> <ul style="list-style-type: none"> • The cost model (cost less any accumulated impairment losses). • The equity method. • The fair value through profit or loss model. 	<p>The revised IAS 28 <i>Investments in Associates and Joint Ventures</i> (effective date: 1 January 2014) requires an investor to account for investments in associates and joint ventures using the equity method only. Some exceptions are in place – for example, when the investment is classified as held for sale.</p>
Expense recognition	
<p>All research and development costs and all borrowing costs are expensed immediately.</p>	<p>Research costs are expensed as incurred; development costs are capitalised and amortised, but only when specific criteria are met (IAS 38 <i>Intangible Assets</i>). Borrowing costs are capitalised if certain criteria are met (IAS 23 <i>Borrowing Costs</i>).</p>

Financial instruments – derivatives and hedging

There are two sections dealing with financial instruments: a section for simple payables and receivables, and other basic financial instruments; and a section for other, more complex financial instruments. Most of the basic financial instruments are measured at amortised cost; the complex instruments are generally measured at fair value through profit or loss.

IAS 39 *Financial Instruments: Recognition and Measurement* classifies four types of financial instruments – financial assets or liabilities at fair value through profit or loss, held-to-maturity investments, loans and receivables and available-for-sale financial assets.

Non-financial assets and goodwill – initial recognition

The cost model is the only permitted model.

For tangible and intangible assets, there is an accounting policy choice between the cost model and the revaluation model.

Non-financial assets and goodwill – subsequent recognition

There is no distinction between assets with finite or infinite lives. The amortisation approach therefore applies to all intangible assets including goodwill. These intangibles are tested for impairment only when there is an indication.

Under IAS 38 *Intangible Assets*, the useful life of an intangible asset is either finite or indefinite. The latter (including goodwill) are not amortised and an annual impairment test is required.

Investment property

Investment property is carried at fair value if it can be measured without undue cost or effort.

IAS 40 *Investment Property* offers a choice of fair value and the cost method.

Assets held for sale

Assets held for sale are not covered; the decision to sell an asset is considered an impairment indicator.

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires non-current assets to be classified as held for sale where the carrying amount is recovered principally through a sale transaction rather than through continuing use.

Employee benefits – defined benefit plans	
Requires immediate recognition and splits the expense into different components.	Under IAS 19 <i>Employee Benefits</i> , actuarial gains or losses can be recognised immediately or amortised into profit or loss over the expected remaining working lives of participating employees.

Exhibit 8.1: IFRS for SMEs versus full IFRSs

Worldwide adoption of IFRS for SMEs

According to the IFRS Foundation, there are more than 80 countries which have adopted or announced plans to adopt the IFRS for SMEs. There are 11 markets in Asia, including Singapore, Hong Kong, Malaysia and the Philippines, which have adopted the SME standards. However, the application in Europe is less popular and only three states (Bosnia, Estonia, and Macedonia) have adopted it as at September 2012.

The European Commission conducted a public consultation on IFRS for SMEs in 2010. Divergent opinions were expressed by respondents on the potential application of IFRS for SMEs in Europe. The European Commission (2010) summarised the main results from the public consultation as follows: “It appears clear that in certain Member States the linkage between taxation and capital maintenance rules could make application of IFRS for SMEs more burdensome for some companies by duplicating reporting requirements. However, there was also considerable support for using this Standard, especially for companies with subsidiaries in different Members States, companies seeking international finance, and companies either listed on non-regulated markets or considering a future listing. Using the Standard for consolidated accounts was seen as a possible compromise in those jurisdictions where the linkage between accounting, taxation and capital maintenance rules would make application of the Standard problematic in company annual accounts.”

The European Commission (2010) also discussed the major considerations of proponents and opponents. “Many respondents commented that accounts’ users would benefit from widespread adoption of the Standard mainly due to an increased ability to analyse and compare financial statements prepared in different jurisdictions. Others reported potential benefits including expanded cross-border trade, increased international growth of companies, more foreign merger and acquisition activity, a lowering of the cost of capital and a broadened capital base. Opponents to the application of IFRS for SMEs in Europe stressed the complexity of the Standard, especially for small companies. They feared that setup costs could outweigh potential benefits from the Standard. For enterprises that are active only locally, there is little need for international comparability. It was noted that users are accustomed to national accounting rules and in many cases prefer them to international standards.”

Quagli and Paoloni (2012) analysed the public consultation results and found that there was substantial diversity among respondents. In particular, they found that preparers demonstrated a strong opposition to IFRS for SMEs, while users were more favourable. A more interesting finding was that German-speaking countries and Latin countries showed much less appreciation for that standard with respect to Anglo–Nordic countries. It seems that the challenges to the adoption of IFRS for SMEs are not only the different needs of users and preparers but also cultural differences.

Benefits of adopting the SFRS for Small Entities

- Reducing compliance costs
- Tailoring to different user needs
- Improving access to capital
- Reducing the cost of capital

The application of IFRS for SMEs in Singapore

The Accounting Standards Council of Singapore (ASC) adopted IFRS for SMEs as the Singapore Financial Reporting Standard for Small Entities (SFRS for Small Entities) as at 30 November 2010. Small entities in Singapore may opt to apply SFRS for Small Entities for annual periods beginning on or after 1 January 2011. The ASC believes that “IFRS for SMEs is a robust and comprehensive standard that is premised on the principles of the full IFRSs framework and is internationally recognised as a high quality standard” and hence the SFRS for Small Entities is largely aligned to the IFRS for SMEs. The main difference is the description of the scope and applicability of the SFRS for Small Entities which does not constitute a deviation from the IFRS for SMEs.

The IFRS for SMEs defines SMEs as entities that: (a) do not have public accountability, and (b) publish general purpose financial statements for external users. In addition to the two criteria, the SFRS for Small Entities defines the size criterion of SMEs. Small entities must satisfy at least two of the three following criteria: (i) total annual revenue of not more than S\$10 million; (ii) total gross assets of not more than S\$10 million; and (iii) total number of employees of not more than 50 to be eligible to adopt the SFRS for Small Entities.

The application of SFRS for Small Entities in Singapore is growing. According to statistics from Accounting and Corporate Reporting Authority of Singapore (ACRA), in 2012, there were 1,897 small entities (including 349 first-year incorporated entities) which filed financial statements using the SFRS for Small Entities taxonomy version. However, it only accounted for about 4 per cent of the total number of non-listed companies which have revenue or total assets of not more than \$10 million. ACRA has been encouraging more small entities to consider the adoption of SFRS for Small Entities.

Considerations prior to adopting SFRS for Small Entities

If a small entity is eligible to apply SFRS for Small Entities, a thorough cost-benefit analysis should be done by its board of directors. We outline below some major considerations for a small entity before it adopts the standard.

What is the effect on an entity's financial metrics?

One of the key benefits of financial reporting for SMEs is to increase access to capital by providing higher quality financial information. However, different accounting policies may result in different financial ratios and profits which may have some negative impact on existing debt covenants and terms and conditions of contractual arrangements. It may also result in different amounts of taxes payable, the ability to pay dividends and management compensation. The significance of the impact depends on the facts and circumstances surrounding each entity. The key is to balance the costs and benefits of adopting a new accounting standard.

What are the entity's long-term goals?

The full SFRS is required for entities with public accountability (such as public listed companies). Thus, if the entity has a long-term plan to issue public shares and get listed on a stock exchange, the entity must consider the transition costs from SFRS for Small Entities to the full SFRS. Once again, the decision should be based on whether the potential benefits from adopting a simplified standard can exceed the costs.

How much is the budget for the transition?

An entity must incur some monetary costs when adopting a new reporting standard. Hence, a detailed budget is necessary to better understand the cost of adoption. The initial adoption of SFRS for Small Entities may require some upfront investment resulting from system changes, reformatting of the financial statements and training costs (including subsequent ongoing training of staff which may be negligible because of the simplified redrafting of the standard). The entity may also need to pay extra advisory fees to professionals for the conversion to a new standard.

Conclusion

More than 95 per cent of entities are small and medium-sized entities. These SMEs have much simpler organisational structure and business model than larger entities. Hence, they demand a less complex financial reporting standard. The IFRS for SMEs (SFRS for Small Entities in Singapore) is a simplified version of the full IFRSs and we expect it will provide similar quality of financial reporting as the full IFRS does. The costs and benefits of adopting the IFRS for SMEs have been discussed in this chapter and a summary of major differences between the full IFRSs and the IFRS for SMEs also presented. We observed that about 4 per cent of Singapore SMEs are adopting the new standard and the numbers are counting. We encourage eligible SMEs in Singapore to conduct a thorough cost-benefit analysis and consider adopting the SFRS for Small Entities to reduce their compliance costs.

References and further reading

European Commission (2010), “Commission’s Consultation on the International Financial Reporting Standard for Small and Medium-sized Entities” [URL](#)

IFRS Foundation (2012), “IFRS for SMEs Fact Sheet” [URL](#)

KPMG (2010), “The IFRS for SMEs: Considering the Alternatives” [URL](#)

PricewaterhouseCoopers (2009), “Similarities and differences: A comparison of ‘full IFRS’ and IFRS for SMEs” [URL](#)

Quaglia, A. and P. Paoloni (2012), “How is the IFRS for SME accepted in the European context? An analysis of the homogeneity among European countries, users and preparers in the European commission questionnaire”, *Advances in Accounting*, 28(1), pp 147–156 [URL](#)

Suwardy, T (2010), “New accounting rules a blessing for SMEs”, *The Business Times*, 18 Nov 2010, page 22 [URL](#)

Part 2 Technical Updates

Chapter 9

Fair Value

Measurement

Andre Toh & Lim Yuan Sing, Ernst & Young Solutions LLP

Introduction

Fair value is a market-based measurement basis that is commonly used in financial reporting. Proponents cite its key advantage being relevance to users of financial statements as it reflects economic realities and actual transactions. However, skeptics have raised concerns over its subjectivity and reliability, especially in cases where complex valuation models are involved. Fair value measurements are often cited by financial statements preparers to be one of the most challenging aspects of financial reporting.

Until recently, guidance in IFRS (and hence SFRS in Singapore) on fair value measurement was limited and dispersed throughout various standards that required the use of fair value measurement, and in some cases, the guidance was conflicting. In May 2011, *IFRS 13 Fair Value Measurement* (the equivalent standard FRS 113 was issued by the Accounting Standards Council of Singapore in September 2011), which is the standard dedicated to how fair value should be measured, was issued on completion of the joint project between the International Accounting Standards Board and US Financial Accounting Standards Board to improve and converge fair value measurement guidance.

This chapter is dedicated to the fair value measurement guidance provided in IFRS 13/FRS 113 with the aim of providing financial statements preparers a handle on its key concepts and requirements. Practical considerations on financial reporting valuations are also featured in the last section in tabular format to serve as quick reference guides. This chapter is neither intended to be comprehensive nor exhaustive regarding fair value measurements. It is recommended that this chapter be read in conjunction with the requirements of IFRS 13/FRS 113.

The diagrams and tables featured herein were published in the Fair Value Measurement chapter in Ernst & Young's "International GAAP® 2013 - Generally Accepted Accounting Principles under International Financial Reporting Standard". They are reproduced by permission of Ernst & Young © 2013 EYGM Limited. All Rights Reserved.

Scope and definition

IFRS 13/FRS 113 is applied whenever fair value is used as a measurement basis under another standard (e.g. financial instruments, investment properties, biological assets, purchase price allocation for business combinations), or for disclosure purposes. However, it does not apply to valuation for lease accounting (under IAS 17/FRS 17 Leases), share-based payments accounting (under IFRS 2/FRS 102 Share-based Payment), as well as fair value disclosures of certain assets and liabilities as detailed in the section on disclosures below.

IFRS 13/FRS 113 (Appendix A) defines fair value as *"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"*.

Fair value measurement framework, key concepts and clarifications

IFRS 13/FRS 113 provides a framework with distinct but interrelated components for applying the fair value definition to financial reporting. It also provides clarifications on specific concepts that need to be taken into account for fair value measurement purposes.

The following diagram illustrates a view of the interdependence of the various components of the fair value measurement framework according to IFRS 13/FRS 113. The key concepts, components and clarifications on fair value measurements are explained further below.

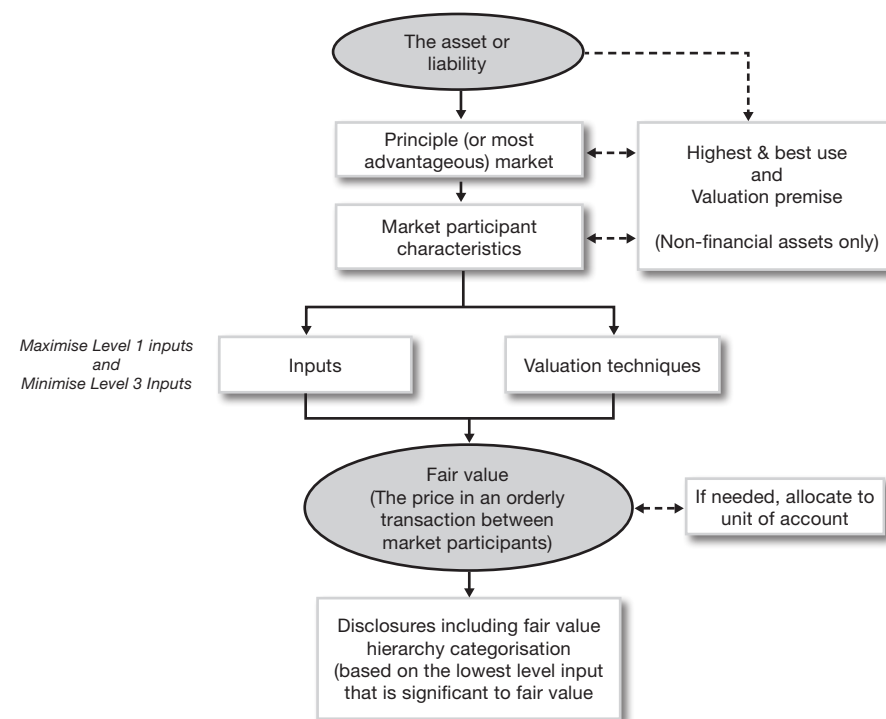


Exhibit 9.1: Fair value measurement framework

Key concepts and components

The key concepts and components of fair value measurements are explained further in the table below.

Key concepts and components		Examples of practical implications
1) Exit price in the principal (or most advantageous market)	Fair value is an exit price, i.e. price to sell an asset or transfer a liability as opposed to price to buy an asset or assume a liability (entry price). The relevant market for the exit price is the principal market, i.e. the market with the highest volume and level of activity for the asset. Only in the absence of a principal market, it is assumed that the transaction would occur in the most advantageous market. This is the market that would maximise the amount that would be received to sell an asset or minimise the amount that would be paid to transfer a liability, taking into account transport and transaction costs. In either case, the entity must have access to the market on the measurement date.	For the purposes of fair value measurement, the purchase price of an asset is an entry price, which should not be presumed to be equal to or approximates the exit price. Even if the entry price reasonably approximates the exit price (e.g. purchase of quoted stocks from an active market with minimal bid-ask spread), one needs to make considerations as to whether the purchase was in the principal market (or if absent, the most advantageous market) for selling the asset or transferring the liability.
2) Characteristics of the asset or liability being measured	Fair value measurements should take into consideration the characteristics of the valuation subject but not the characteristics of the transaction. While transaction costs are considered in determining the most advantageous market, they do not form part of the fair value (i.e. they are not adjusted from the price used to measure fair value) since they are characteristics of the transaction. An exit price would be adjusted for transportation costs if location is a characteristic of the asset or liability being measured.	In valuing a new machine manufactured in Germany that is currently installed and operating in a factory in Singapore using the replacement cost approach, the entity needs to take into account amongst other things, the cost of shipping the machine from Germany to Singapore and installing it.

Key concepts and components		Examples of practical implications
3) Market participants characteristics	Fair value is a market-based measurement, not an entity-specific measurement. When determining fair value, management uses the assumptions that market participants would use when pricing the asset or liability. Although an entity needs not identify specific market participants, considerations are made to ensure that they possess the characteristics of independence from each other, being knowledgeable and having a reasonable understanding about the asset or liability using all available information, being willing (not forced) and able to enter into a transaction for the asset or liability.	When developing discount rates used in valuation of an asset using discounted cash flows (income approach), e.g. Weighted average cost of capital (WACC), assumptions used such as debt-equity ratio, cost of debt capital, and volatility of equity price are based to the extent available on rates observed for comparable companies instead of the entity's unique costs of debt and equity capital.
4) Orderly transaction hypothesis	Fair value is a hypothesis of the price at which an orderly transaction would take place between market participants at the measurement date. Additional considerations need to be made if there are evidence that valuation inputs are derived from transactions that are not orderly, in distressed markets, or where there have been significant decrease in volume and level of activity in the market.	Transaction prices indicated in "fire sale" of assets such as properties in a mortgage crisis, or regulator enforced sale of assets may need to be adjusted or placed less weight on for fair value measurement purposes.

Exhibit 9.2: Key concepts and components of fair value measurements

Key clarifications on fair value measurements

Unit of account matters: Fair value measurements take into consideration the characteristics of the asset or liability being measured and also the sale or transfer hypothesis based on its unit of account. The unit of account determines the subject of fair value measurement.

Unit of account is the level at which an asset or a liability is aggregated or disaggregated for financial reporting under IFRS/SFRS. For example, consider that the unit of account for an investment in shares accounted for under *IAS 39/FRS 39 Financial Instruments: Recognition and Measurement* is the individual instrument. Discounts to be included in the fair value measurement are those that would apply to a single share even though the entity might hold a more significant stake in such shares, e.g. 15 per cent of total shares.

There are, however, certain specific considerations to the application of unit of account for fair value measurement purposes, including (i) the prohibition to making blockage factors adjustment for the size of an entity's holding in comparison to current trading volumes since this is a characteristic of the holding rather than the asset itself; (ii) the requirement to adopt as fair value measurement basis, the quoted price of an identical financial instrument in an active market when it is available (commonly known as the "Price x Quantity" or "PxQ" approach), notwithstanding that the unit of account for the asset is not the single instrument; and (iii) if the entity qualifies for and elects to apply the exception to measure financial instruments within the scope of IAS 39/FRS 39 with offsetting risks on a portfolio basis rather than on a single instrument basis. Note that (ii) is consistent with the tentative decision made by the staff of the IASB but may be subject to change depending on the final decision of the IASB on this matter.

It is useful to note that other than unit of account, there is another distinct concept referred to as "valuation premise" in IFRS 13/FRS 113 that deals with the level of aggregation (or disaggregation) for assets and liabilities, albeit purely from a valuation perspective in making assumption of the highest and best use of non-financial assets as discussed below.

Highest and best use of non-financial assets and valuation premise:

Fair value measurement of non-financial assets must reflect the highest and best use of the non-financial asset from a market participant's perspective, i.e. the use that would maximise the value of the asset or the group of assets and liabilities (e.g. business) within which the asset would be used. Highest and best use is presumed to be the entity's current use unless an alternative use is suggested by market or other factors. Highest and best use also establishes whether to assume for valuation purposes, a market participant would derive value from using the non-financial asset on its own (e.g. licensing a design patent to other users) or in combination with other assets or with other assets and liabilities (e.g. using a design patent in the process of manufacturing goods). This level of aggregation (or disaggregation), for valuation purposes, is referred to as "valuation premise". It is important to note that even when fair value measurement assumes that the highest and best use of the asset is to use it in combination with other assets or with other assets and liabilities, the fair value measurement of a non-financial asset assumes that the asset is sold consistently with the unit of account specified in the relevant IFRS/SFRS assuming that market participants have or are able to obtain all the assets and liabilities that would be used in combination with the non-financial asset being sold.

Highest and best use of a non-financial asset is determined based on whether the use is physically possible, legally permissible and financially feasible. As such, when assessing current and alternative uses, entities should consider the physical characteristics of the asset (e.g. when considering whether an industrial land plot can be converted into a residential-use land plot in order to maximise its value, entities should also consider whether it is at a location that is suitable for development into a residential property); any legal restrictions on its use (e.g. whether zoning regulations allow or may potentially allow the industrial land plot to be converted into a residential-use land plot); and whether the value generated provides an adequate investment return for market participants (e.g. when evaluating whether the value is maximised by converting the industrial land plot into a residential-use land plot, entities should assess its financial feasibility such as the costs and uncertainties of obtaining the approval for a change in its use, and the necessary costs and

risks relating to the conversion of the land plot from its current condition to the alternative use.).

Determining the highest and best use of a non-financial is an area of significant judgement that requires the entity to have a good understanding of the circumstance surrounding the asset (e.g. industry developments and practices of sector peers). Furthermore, as circumstances change, a reassessment of highest and best use is required.

Selecting valuation techniques and inputs: The guidance and requirement on valuation techniques in IFRS 13/FRS 113 are broad and apply to all methods of measuring fair value that it recognises, which are the market approach, income approach and the cost approach. These approaches are consistent with generally accepted valuation methodologies used outside financial reporting. Their applicability to the asset or liability measured is a function of their appropriateness in the circumstance considering IFRS 13/FRS 113 measurement objectives, sufficiency of data, and market practices. Other than the requirement to maximise observable inputs, IFRS 13/FRS 113 does not prioritise the use of one valuation technique over another, with the exception of the requirement to measure identical financial instruments that trade in active markets using the PxQ approach as mentioned above.

IFRS 13/FRS 113 recognises three valuation approaches to measure fair value:

- **Market approach:** based on market transactions involving identical or similar assets or liabilities (e.g. using current bid-price of identical instrument when valuing quoted equity instruments).
- **Income approach:** based on future amounts (e.g. cash flows or income and expenses) that are converted (discounted) to a single present amount (e.g. relief from royalty method that is commonly used to value brands and trademarks).
- **Cost approach:** based on the amount required to replace the service capacity of an asset (e.g. current replacement cost methods used to value plant and equipment assets).

IFRS 13/FRS 113 establishes a hierarchy for the inputs used in those valuation techniques, requiring an entity to maximise observable inputs (“Level 1” and “Level 2” inputs) and minimise the use of unobservable inputs (“Level 3” inputs) (the fair value hierarchy and its implications are discussed further in the section below). It also indicates that multiple techniques should be used when appropriate and sufficient data is available. In practice, there are many variants in which multiple techniques are used such as selection of one primary method which maximises the use of observable inputs while another technique is adopted as the secondary method to serve as a cross-check of the results of the primary method, or the range of fair value measurement is based on results derived from multiple techniques.

Valuation of liabilities and an entity’s own equity instruments: IFRS 13/FRS 113 provides a measurement framework on how to measure the fair value of liabilities and an entity’s own equity instruments (e.g. ordinary shares). It also clarifies that a fair value measurement of a liability must consider non-performance risk, which includes, but is not limited to, an entity’s own credit risk, and is assumed to remain unchanged upon the transfer that is assumed in the fair value definition. Furthermore, it states that the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. This is consistent with previous requirements in IAS 39/FRS 39. It should be highlighted that the fair value definition assumes that the liability or entity’s own equity instrument that is being transferred remains outstanding and is not settled or extinguished. In practice, valuations adopting assumptions of settlement or extinguishment warrant different valuation considerations as compared to valuations that assume that the instruments remain outstanding, and this may lead to significantly different valuation outcomes.

For fair value measurement of a liability and an entity’s own equity instrument, the first reference point is the quoted prices available for the transfer of an identical or a similar liability or entity’s own equity instrument. If no such quoted price is available but the identical item is held by another party as an asset

(e.g. bonds issued by an entity are held by investors as investment securities asset), the entity uses the fair value of the corresponding asset (from the perspective of the market participant that holds that asset) to measure the fair value of the liability or equity instrument. When no corresponding asset exists (e.g. obligations for environment rehabilitation are not held by another party as an asset), the fair value of the liability is measured from the perspective of a market participant that owes the liability, which is commonly based on a present value technique that takes into account the future cash outflows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation.

Fair value hierarchy and its implications

The fair value hierarchy adopted in IFRS 13/FRS 113 is consistent with the fair value hierarchy for disclosures relating to financial instruments that was first introduced in *IFRS 7/FRS 107 Financial Instruments: Disclosures*. It classifies the inputs used to measure fair value into three levels, which are described in the table below.

	Level 1	Level 2	Level 3
Definition	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.	Unobservable inputs for the asset or liability.
Example	The price for a financial asset or financial liability for the identical asset that is traded on an active market (e.g. London Stock Exchange).	Interest rates and yield curves observable at commonly quoted intervals, implied volatilities, and credit spreads.	Projected cash flows used in a discounted cash flow calculation.

Exhibit 9.3: Definition and example of fair value hierarchy (source: IFRS 13/FRS 113 Appendix A)

The fair value hierarchy serves to increase consistency and comparability in fair value measurements and the related disclosures in two key ways:

1. Guides the prioritisation in the selection of valuation approaches and inputs in a fair value measurement by requiring entities to maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The following table shows examples of the implications. Note that depending on the pertinent facts and circumstances of each fair value measurement, the result of the application of the fair value hierarchy may not yield the same results suggested in these examples.

Quoted shares	Unquoted shares	Brand/trade mark
Adopting observed quoted price in an active market without adjustment as basis of fair value.	Adopting comparable companies approach based on observed trading/transaction multiples instead of the income approach as primary valuation approach.	Adopting the relief-from-royalty approach based on observed comparables' royalty rate instead of the multi-period excess earnings method as primary valuation approach.

Exhibit 9.4: Examples of fair value hierarchy's implications to selection of valuation techniques and inputs

2. Mandates the nature and extent of fair value measurement disclosures based on the categorisation of the fair value measurement as a whole, i.e. the lowest level input that is significant to the fair value measurement as a whole. IFRS 13/FRS 113 considers significance in relation to the entire fair value measurement rather than the quantum or earnings impact of the resulting change in fair value due to the input per se. There is no "bright-line" provided as reference point to assess significance in IFRS 13/FRS 113. The assessment of significance will require judgement and consideration of factors specific to the valuation subject and it is recommended that a documented policy for making such assessments be put in place. The following table shows an example of fair value categorisation's implication to IFRS 13/FRS 113 disclosure requirements.

	Fair Value Measurement (Case A)	Fair Value Measurement (Case B)
Lowest level input that is significant to the fair value measurement	Multiple of earnings derived from observed transactions involving comparable businesses, taking into account operational, market, financial and non-financial factors used in the market approach for measuring fair value less costs of disposal of a cash generating unit.	Cash flows forecast developed using entity's own data used in the income approach for measuring fair value less costs of disposal of a cash generating unit.
Fair value measurement category	Level 2	Level 3
Examples of additional disclosure requirements	In addition to Level 1 measurements: Description of valuation technique(s) and inputs used. Disclosure of any changes in valuation technique(s), and reasons for the change.	In addition to Level 2 measurements: Quantitative information about significant unobservable inputs Description of valuation processes.

Exhibit 9.5: Examples of fair value hierarchy categorisations and their implication to disclosure requirements

Disclosures relating to fair value measurements

IFRS 13/FRS 113's disclosure objectives are to help users of financial statement assess both: i) the valuation techniques and inputs used to develop fair value measurements for assets and liabilities that are measured at fair value (recurring or non-recurring basis) in the statement of financial position at the reporting date, and ii) the effect of recurring fair value measurements using significant unobservable inputs (Level 3) on profit or loss or other comprehensive income for the period. It requires a number of minimum disclosures designed to provide users of financial statements with transparency regarding:

- The extent to which fair value is used to measure assets and liabilities
- The valuation techniques, inputs and assumptions used in measuring fair value (i.e. how did the entity arrive at the fair value amounts)
- The effect of Level 3 fair value measurements (being more subjective) on profit or loss (or other comprehensive income)

The following table summarises the scope and applicability of the IFRS 13/FRS 113 disclosure requirements. The left column relates to items whereby IFRS 13/FRS 113 disclosure requirements would have to be applied, while the right column relates to items whose fair value disclosure requirements are contained in the relevant standards.

Apply IFRS 13/FRS 113 disclosure requirements	Apply disclosure requirements in the relevant standards instead
<ul style="list-style-type: none"> • Items carried at fair value in the balance sheet at the reporting date except those in the next column. • Items not carried at fair value but of which fair value at the reporting date is required to be disclosed by the relevant standard, e.g. investment properties accounted for using the cost model under <i>IAS 40/FRS 40 Investment Properties</i>, and financial instruments carried at amortised cost under <i>IAS 39/FRS 39</i>. 	<ul style="list-style-type: none"> • Plan assets measured at fair value in accordance with <i>IAS 19/FRS 19 Employee Benefits</i>. • Retirement benefit plan investments measured at fair value in accordance with <i>IAS 26/FRS 26 Accounting and Reporting by Retirement Benefit Plans</i>. • Assets for which recoverable amount is fair value less costs of disposal in accordance with <i>IAS 36/FRS 36 Impairment of Assets</i>.

Exhibit 9.6: The scope and applicability of the IFRS 13/FRS 113 disclosure requirements

The following are key factors to consider when applying IFRS 13/FRS 113 disclosure requirements:

Format	<ul style="list-style-type: none"> Use a tabular format to present the quantitative disclosures, unless another format is more appropriate.
Level of detail and disaggregation	<ul style="list-style-type: none"> Disclosures should be made by classes of assets and liabilities, which may not be identical to classes specified by the relevant standards (e.g. IAS 16/FRS 16 <i>Property, Plant and Equipment</i> and IAS 39/FRS 39). Determination of the classes is based on both: (a) the nature, characteristics and risks of the asset or liability; and (b) the level of the fair value hierarchy within which the fair value measurement is categorised. It also depends on management's judgement, the pertinent facts and circumstances, and the needs of users of its financial statements. Disclosures of Level 3 fair value measurements are expected to be more disaggregated than those categorised in higher levels, and there should be sufficient detail to permit reconciliation back to the balance sheet.
Key drivers and triggers of disclosure requirements	<ul style="list-style-type: none"> Fair value hierarchy categorisation of the fair value measurement (e.g. Level 3 fair value measurements require more disclosures) and transfers of items between such categories. Fair value being used as measurement basis at reporting date (not merely being disclosed), and the recurring nature of fair value measurement at each reporting date as opposed to non-recurring measurements. Refer to the tables below for such examples. A change in valuation technique(s) used. Highest and best use assumption for non-financial assets differing from entity's current use. Presence of liability measured at fair value and issued with an inseparable third-party credit enhancement. Application of IFRS13/FRS 113 portfolio exception for group of financial assets and financial liabilities with offsetting positions in market risks or credit risk.
Whether users need additional disclosures	<ul style="list-style-type: none"> Additional disclosures should be provided if the minimum requirements of IFRS 13/FRS 113 do not result in the disclosure objectives being met.

Exhibit 9.7: Key factors to consider when applying IFRS 13/FRS 113 disclosure requirements

Measured at fair value on a recurring basis at each reporting date	Measured at fair value on a non-recurring basis (after initial recognition)	Not measured at fair value, but fair value is required to be disclosed
<ul style="list-style-type: none"> Investment properties accounted for using the fair value model Biological assets Fixed assets accounted for using the revaluation model Investment securities accounted for as financial instruments Derivatives Contingent consideration 	<ul style="list-style-type: none"> Non-current assets or disposal groups classified as held for sale 	<ul style="list-style-type: none"> Investment properties carried at cost Financial assets and liabilities at amortised cost (e.g. intercompany loans, bank loans, long-term receivables, held to maturity debt investments)

Exhibit 9.8: Examples of account items that trigger disclosures

	Measured at fair value on a recurring basis	Measured at fair value on a non-recurring basis (after initial recognition)	Not measured at fair value, but fair value is required to be disclosed
Fair value at end of reporting period	✓	✓	✓ (this is required by other IFRSs/SFRSs)
Reasons for measurement		✓	
Level of fair value hierarchy	✓	✓	✓
Amounts of transfers between Level 1 and Level 2, reasons for transfers and policy for determining when transfers occurred	✓		

If highest and best use differs from current use, that fact, and why being used that way	✓	✓	✓
For Level 2 and 3, a description of valuation technique(s) and inputs used	✓	✓	✓
For Level 2 and 3, any changes in valuation technique(s), and reasons for change	✓	✓	✓
For Level 3, quantitative information about significant unobservable inputs	✓	✓	
For Level 3, description of valuation processes	✓	✓	
For Level 3, a reconciliation from the opening balances to the closing balances, separately disclosing changes during the period	✓		
For Level 3, the amount of the total gains or losses for the period included in profit or loss that is attributable to the change in unrealised gains or losses and the line item(s) in profit or loss in which those unrealised gains or losses are recognised	✓		
For Level 3, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs	✓		
For Level 3 financial assets and financial liabilities, quantitative sensitive analysis	✓		

Exhibit 9.9: Disclosure requirements driven by the extent of fair value measurement being included in reporting of financial position and performance

Practical valuation considerations for preparers of financial statements

Preparers of financial statements are increasingly expected to possess the following competencies in respect of fair value measurements:

- working knowledge of IFRS 13/FRS 113 guidance and requirements
- effectively engage and direct a valuer to perform fair value measurement on a timely basis
- understand and evaluate the valuer's work and results, valuation approaches selected, and key assumptions used
- convey valuation results, key inputs and implications to users of financial statements and stakeholders

The following is a compilation of practical considerations on financial reporting valuation that may be useful to accountants who are required to manage the financial reporting valuation process. These practical considerations are based on the general experiences of accountants and valuers who are involved in financial reporting valuations. They are in summarised form, non-exhaustive, and require the application of professional judgement.

Valuer	Competent, experienced, objective, independent, and accredited if required by market practice or regulations.
Valuation subject	Clearly identified, defined and based on appropriate unit of account.
Purpose	Clearly stated for financial reporting or other compatible purposes.
Basis of value	Basis adopted is consistent with fair value definition in IFRS 13/FRS 113.
Valuation date	At or on a date (and time if applicable) suitable for financial reporting.
Valuation techniques	Generally accepted, appropriate in the circumstance, having sufficient available data, and maximises the use of observable inputs.

Extent of procedures	Adequate considering materiality, subjectivity, and sensitivity of the fair value measurement.
Sources of information	Clearly identified, relevant in the circumstance, and with clarity on any limitations.
Key assumptions	Clearly documented, with most sensitive inputs identified.
Statement of compliance	IFRS/SFRS, IFRS 13/FRS 113 or generally recognised valuation standards.
Checks and balances	Performs valuation cross-checks with more than one valuation approach if practicable, sensitivity analyses using reasonable range of estimates, and clerical accuracy and model integrity checks.

Exhibit 9.10: High-level considerations for assessing financial reporting valuations

Relevance of distinction	<ul style="list-style-type: none"> • More likely to be applicable to valuations of real estate, capital equipment, intellectual property, and businesses.
Key attributes of full-fledged valuations	<ul style="list-style-type: none"> • Site visit and physical inspection of asset and operations, and legal and technical documents. • Interviews and discussions with management and relevant employees and technical experts. • Use of forecasts and estimates provided by management instead of information developed by valuer.
Key drivers of full-fledged valuations	<ul style="list-style-type: none"> • Regulatory requirements. • Materiality, risks and sensitivity of valuation results. • Access to information, assets and management personnel. • Lack of readily available observable benchmarks and proxies. • Non-availability of recently performed full-fledged valuation.

Exhibit 9.11: Considerations for using “full-scope” or desktop valuations

Valuation or pricing basis, approaches, assumptions, and extent of work	<ul style="list-style-type: none"> • The valuation basis adopted may not be based on market participants’ assumptions that would be used in an orderly transaction as required for financial reporting purposes. For example, the valuation for transaction pricing may be based on: <ul style="list-style-type: none"> - Entity-specific considerations such as its own internal rate of return (IRR) driven by a unique costs of funds structure instead of the rate of return required by market participants. Of worthy highlight, in addition to unsuitability for fair value measurement purposes, transaction pricing that is based on an IRR that is significantly lower than the market required rate of return (e.g. WACC based on comparable businesses) also poses a risk of day-one impairment loss if the asset is required to be measured at fair value. - Transaction parties unique considerations such as in the case of a related party transaction driven by parties-specific strategic objectives. - Seller-specific circumstance such as in the case of a distressed or compelled transaction.
Valuation subject	<ul style="list-style-type: none"> • The valuation subject may be at a higher level than unit of account required for financial reporting purposes.
Valuation date	<ul style="list-style-type: none"> • The valuation date may be driven by bidding, agreement or completion dates, which may not be the same as the valuation date for financial reporting purposes.
Objectivity and independence	<ul style="list-style-type: none"> • The valuer may not be independent of the management and may not have exercised the necessary objectivity.

Exhibit 9.12: Considerations when planning to rely on valuations used for transaction pricing

Value propositions	<ul style="list-style-type: none"> • Does the valuer possess the relevant credentials and experience? (Note that the credentials and experience should be those of the specific valuer or team responsible for performing and delivering the valuation, rather than the firm that the valuer works for). • Is the valuer accredited by a reputable professional body? • Is the valuer a sector expert or a market leader? • Is the valuer well-versed in the fair value measurement guidance and requirements in IFRS 13/FRS 113? • Is the valuer independent and objective? • Is the valuer committed to the time required for engagement and discussions with management and auditors? • Can the valuer provide value adding services such as knowledge transfer?
Costs and fees	<ul style="list-style-type: none"> • Are the costs and fees charged commensurate with the complexity, risks, and time and resources required for the valuation?
Working protocol and terms of reference	<ul style="list-style-type: none"> • Adequate budgeting of time for the selection and engagement of the valuer, the valuation and documentation process, and the management and auditor review process. • Establish common understanding of valuation subject, basis, scope, responsibility, valuation reporting format, and timeline. • Ensure that the valuer understands your fair value measurement and disclosure objectives and can assist you in meeting them, e.g. selection of valuation approaches, inputs and assumptions using IFRS 13/FRS 113 measurement framework; and provision of adequate information about the valuation for disclosure purposes. • Ensure that the terms of reference for the valuation engagement is clear regarding the following key areas: <ul style="list-style-type: none"> - Purpose, date and subject of the valuation. - Definition of value adopted. - Compliance with IFRS 13/FRS 113 measurement framework. - Nature and extent of information regarding the valuation that will be provided in the valuation report or other deliverables. • Ensure that agreement on valuation approaches to be adopted is reached with the management and auditors before the valuer commences the execution of the valuation.

Exhibit 9.13: Considerations for selecting and working with an external valuer

References and further reading

Ernst & Young (2013), "International GAAP® 2013 - Generally Accepted Accounting Principles under International Financial Reporting Standard"

URL

Disclaimer

The views reflected in this article are the views of the authors and do not necessarily reflect the views of the global Ernst & Young organisation or its member firms. This chapter contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgement. On any specific matter, reference should be made to the appropriate advisor.

© 2013 Ernst & Young Solutions LLP. All Rights Reserved. (UEN T08LL0784H)

Chapter 10

Consolidation Suite of New Standards

Reinhard Klemmer & Malgosia Aitchison, KPMG Singapore

Introduction

The new consolidation and disclosure standards have, like the joint arrangement standard that accompanies them, been long in the making. Coming out of the financial crisis, there were concerns among some that the existing standards failed to adequately portray the risks that investors in certain entities were exposed to.

Previously, IFRS had two different consolidation models: one for special purpose entities and the other for all other investees. In its new consolidation standard, *IFRS 10 Consolidated Financial Statements* (FRS 110 in Singapore; we use the Singapore notation in the rest of this chapter), IASB has stated that its objective is to develop a single consolidation model applicable to all investees.

Similarly, the old *FRS 31 Joint Ventures* was exclusively focused on the structure of the arrangement where the presence of a separate vehicle determined the classification, which led to an outcome that economically similar arrangements could be classified differently and vice versa. Further, FRS 31 had a choice of accounting for jointly controlled entities between proportionate consolidation and the equity method. The new standard, *FRS 111 Joint Arrangements*, sets out a test to determine the method of accounting that not only considers the existence of a separate vehicle, but also addresses accounting for the substance.

The IASB's objective of *FRS 112 Disclosures of Interests in Other Entities* is to require disclosures that help users of financial statements evaluate the nature of, and risks associated with, an entity's interests in other entities; and the effects of those interests on the entity's financial position, financial performance and cash flows; and to require of useful information in relation to investees it does not control.

The following figure depicts the generic scope of application of the new suite of consolidation standards depending on the involvement with investees:

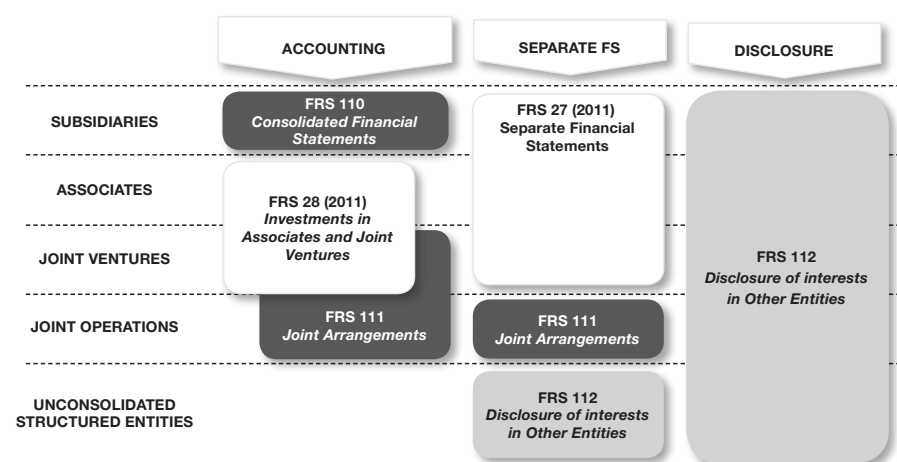


Exhibit 10.1: The new suite of consolidation standards

The new suite of consolidation standards will be of particular importance to the financial services, natural resources and real estate sectors.

In light of the current focus on balance sheet size and capital adequacy ratios, the potential risk to banks consolidating more special purpose vehicles and responsible entities consolidating more managed funds, the impact of the resulting balance sheet gross up may be considerable.

The financial statements of certain resources sectors and real estate companies could be impacted by changes to account for joint arrangements. Some resources companies may no longer be able to proportionately consolidate, but rather will have to apply equity accounting. Some real estate companies may no longer be able to apply equity accounting and have to account for the specific assets and liabilities they own. This could affect key performance measures and ratios.

As the standards are mandatorily effective in Singapore for periods beginning on or after 1 January 2014, we encourage the preparers to start evaluating their involvement with investees under the new framework now, as any changes under these new standards will also in general call for retrospective application.

Consolidation

Overview of the new control model

In accordance with FRS 110, an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee:

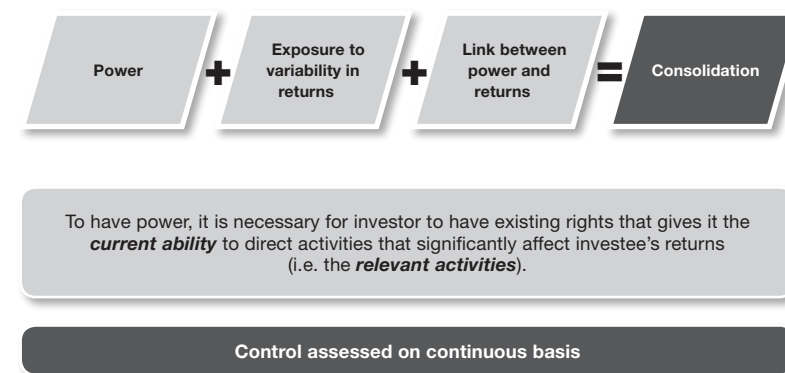


Exhibit 10.2: The new definition of control

The above definition is based on ability to direct the relevant activities, therefore power does not need to be actually exercised. The assessment of control is performed on a continuous basis and the investor reassesses whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the elements of control, e.g. if the investor ceases to receive returns.

The figure below is a general presentation of the analysis to be performed in order to determine whether the rights held by the investor give it control over the investee:

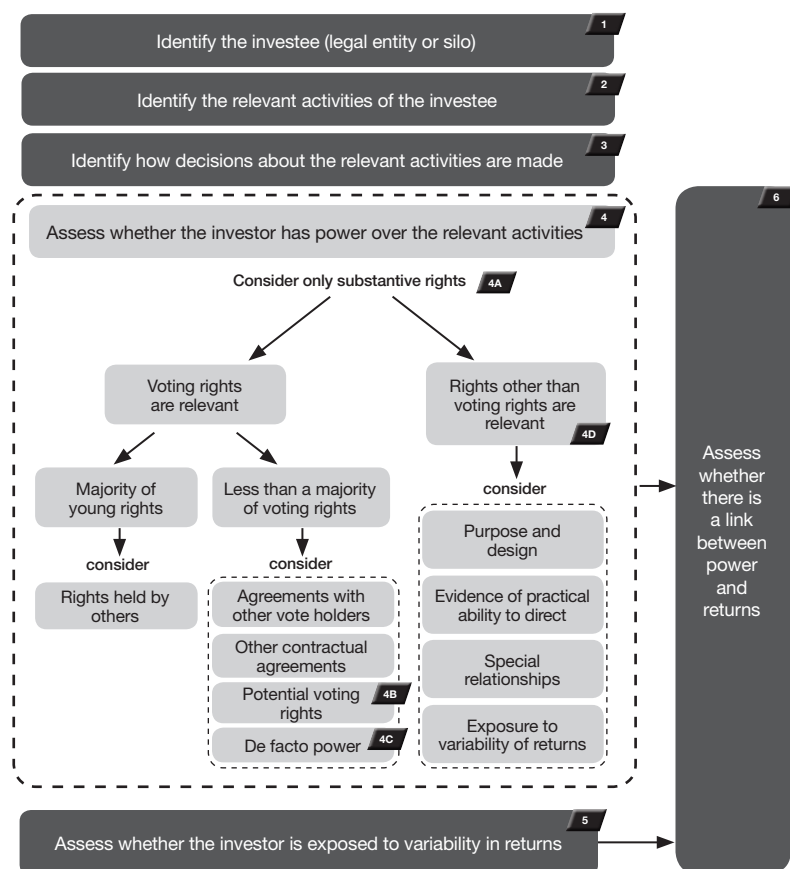


Exhibit 10.3: The process for test of control

We briefly summarise each of the steps in the process for test of control as follows.

1. Control is usually assessed over a legal entity, but can also be assessed over only specified assets and liabilities of an investee (referred to as a silo).
2. The investor considers whether it controls relevant activities of the investee.
3. There is a “gating” question in the model, which is to determine whether voting rights or rights other than voting rights are relevant when assessing whether the investor has power over the investee.
4. A range of factors are considered to assess whether the investor has power over relevant activities:

4A - Only substantive rights held by the investor and others are considered. To be substantive, rights need to be exercised when decisions about the relevant activities need to be made, and their holder needs to have a practical ability to exercise the rights.

4B-4C - An investor can have power over an investee when the relevant activities are directed through voting rights in the following situations:

- the investor holds the majority of the voting rights and these rights are substantive; or
- the investor holds less than half of the voting rights, but has an agreement with other vote holders, holds rights arising from other contractual arrangements, holds substantive potential voting rights (e.g. options), holds rights sufficient to unilaterally direct the relevant activities of the investee (de facto control) or holds a combination thereof.

4D - When holders of voting rights as a group do not have the ability to significantly affect the investee's returns, the investor considers the purpose and design of the investee as well as the following factors (with the first given the greatest weight in the analysis):

- evidence that the investor has the practical ability to direct the relevant activities unilaterally;
- indications that the investor has a special relationship with the investee; and
- whether the investor has a large exposure to variability in returns.

5. Returns are defined broadly and include distributions of economic benefits and changes in value of the investment, as well as fees, remunerations, tax benefits, economies of scale, cost savings and other synergies.

6. An investor that has decision making power over an investee determines whether it acts as a principal or an agent. When the decision maker is an agent, the link between power and returns is absent and the decision maker's delegated power is treated as if it were held by its principal. To determine whether it is an agent, the decision maker considers:

- substantive removal and other rights held by a single or multiple parties;
- whether its remuneration is on arm's length terms; and
- the overall relationship between itself and other parties; through a series of factors.

Consolidation relief for investment entities

A qualifying investment entity is required to account for its investment in controlled entities, as well as investments in associates and joint ventures, at fair value through profit or loss.

To qualify, an entity is required to meet the following tests:

- the entity obtains funds from one or more investors to provide those investors with investment management services;
- the entity commits to its investors that its business purpose is to invest for returns solely from capital appreciation and/or investment income; and
- the entity measures and evaluates the performance of substantially all investments on a fair value basis.

In addition, an investment entity typically has more than one investment, more than one investor, investors are not related parties and ownership interests are in the form of equity or similar interests.

How this could affect you

We set out in the table below the requirements that have been modified in the new control model and that are expected to have an impact on the preparers and users of the financial statements:

Key changes	Potential impacts
Judgemental approach	The approach comprises a series of indicators of control, but no hierarchy is provided, therefore requires an analysis of all facts and circumstances. For example, judgement will be required to assess the design and purpose of an investee.
Single control model applies to all entities	The control conclusion may change for Special Purpose Entities (SPEs) currently within the scope of INT FRS 12. As a result, entities in the financial sector may be impacted. Also, conclusions in respect of entities for which rights other than the voting rights are relevant in assessing control may be impacted, typically in the infrastructure and energy sectors.
Identification of investee activities explicitly required	The control conclusion may change for investees where several investors each have the ability to direct different activities.

Key changes	Potential impacts
De facto control included in the model	More entities could be consolidated if an entity assesses the ability control on a legal/contractual basis under the current framework. There will be some practical challenges for investors to assess de facto control, as it will require knowledge about substantive rights of other shareholders.
Control assessed based on substantive potential rights as opposed to currently exercisable potential voting rights	Management will need to monitor potential voting rights to determine whether they are substantive, which could include the need to assess the investors' practical ability to exercise those rights. This is likely to change the control conclusion: currently exercisable potential voting rights might not be considered substantive and vice versa.
Exposure or right to variability in returns replaces the concept of benefits	Variability in returns is a much broader concept than ownership-type benefits. As a result it may impact the control conclusion, particularly when benefits under the previous control framework were interpreted as ownership-type benefits, such as dividends.
Principal vs. agent guidance explicitly introduced	Some entities may find it difficult to assess whether fund manager remuneration is commensurate with that of other service providers or whether the removal rights held by other parties are substantive. Entities in the funds sector, as well as asset managers, are likely to be impacted.
Guidance provided on when an investor would assess power over silos instead over a legal entity	Explicit guidance on silos is new and may change the control conclusion over a silo and the entity in which it is housed. Entities in financial services and real estate sectors may be impacted..
Protective rights are defined and explicit guidance on kick-out rights is introduced	Guidance provided on the rights of other parties is new and is different to that under US GAAP, which some entities might have been using in the past. Entities in the funds and real estate sector may be impacted.

Exhibit 10.4: Key changes in the new control model

Practical examples

Example 1 – De facto control

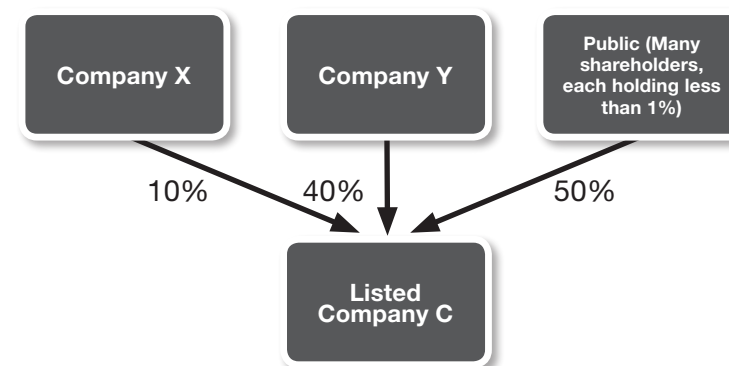


Exhibit 10.5: Example of de facto control

An investor acquires 40 per cent of the voting rights of the investee. 10 per cent voting rights are held by Company X and 50 per cent are held by thousands of shareholders, none individually holding more than 1 per cent of the voting rights. None of these shareholders has any arrangements to consult any of the other or make collective decisions. The investor determines that 40 per cent is sufficient to give it control, because it has sufficiently dominant voting interest to meet the power criterion, on the basis of the relative size of other shareholdings and the absolute size of its holding.

Example 2 – Substantive rights

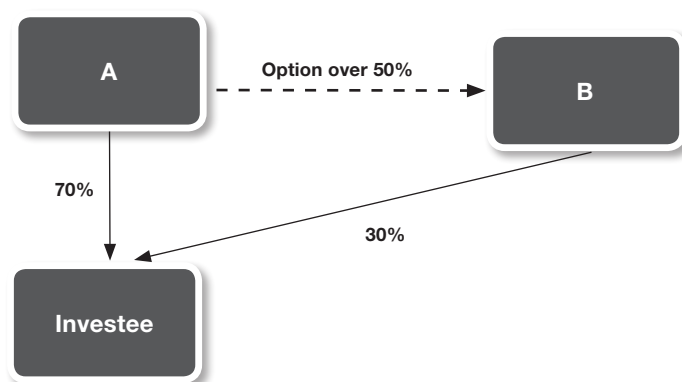


Exhibit 10.6: Example of substantive rights

Investor A holds 70 per cent of the voting rights of the investee. Investor B has 30 per cent of the voting rights of the investee as well as an option to acquire half of the investor A's shares and voting rights. The option is exercisable for the next two years at a fixed price that is deeply out of the money (i.e. the price to be paid for exercising the option is much higher than the current market price for the shares) and is expected to remain so for the next two years. Investor A has been exercising its votes and is actively directing the activities of the investee. Investor A is likely to meet the power criterion, because it has the current ability to direct the relevant activities. Although investor B holds a currently exercisable option, the option is not considered to be substantive because of its terms and conditions.

Example 3 – linkage between power and exposure to variability of returns

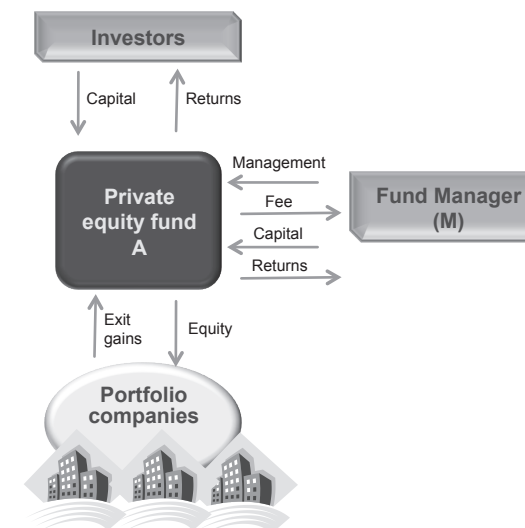


Exhibit 10.7: Linkage between power and exposure to variability of returns

A decision maker (fund manager) establishes, markets and manages Fund A according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. Within the defined parameters the manager has discretion about the assets in which to invest. The manager has 10 per cent investment in the fund and receives a market fee for its services of 1 per cent of the net asset value of the fund, which is commensurate with the services provided. The fund is not required to establish an independent board of directors. The investors do not hold any substantive rights that would affect the decision making authority of the manager. The manager has decision making rights that give it current ability to direct the relevant activities of the fund.

The remuneration and its investment expose the manager to variability of returns from the activities of the fund without creating an exposure that is of such significance that it indicates that the manager is a principal. Thus, the manager is considered to act as an agent for the investors and does not consolidate the fund.

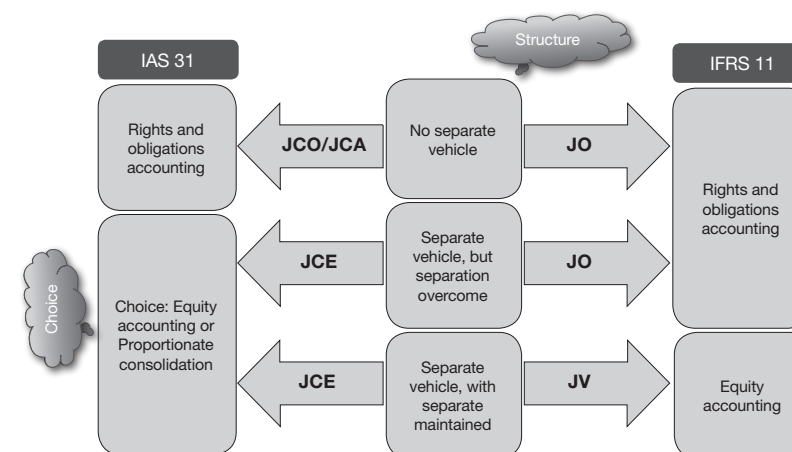
Joint control

Overview of the new joint control model

Under FRS 111, joint arrangements are essentially defined in the same way as under FRS 31: an arrangement over which there is joint control. The following is what is new:

- The way in which FRS 111 sub-categorises joint arrangements into:
 - joint operations, whereby parties with joint control have rights to the assets, and obligations for the liabilities, relating to the arrangements; and
 - joint ventures, whereby the parties with joint control have rights to the net assets of the arrangement.
- The carve out from FRS 31 jointly controlled entities, those cases in which, although there is a separate vehicle, the separation is ineffective and such arrangements are treated similarly to jointly controlled assets/operations under FRS 31 – they are now called joint operations.
- Eliminating the choice of accounting for jointly controlled entities using either proportionate consolidation or equity accounting; joint ventures are accounted for using the equity method only. The proportionate consolidation is no longer allowed, instead joint arrangements are accounted for line by line for the underlying assets and liabilities of the investor.

The difference between the joint arrangement classification and accounting models of the previous and the new frameworks can be illustrated as follows:



Key: JCO/JCA: Jointly controlled operation/jointly controlled asset JO: Joint operation
JCE: Jointly controlled entity JV: Joint venture

Exhibit 10.8: The changes in the classification and accounting models for joint arrangement

The key in determining the type of the arrangement, a joint operation or a joint venture, is the analysis of the rights and obligations of the parties arising from the arrangement in the normal course of business. An entity determines the type of joint arrangement by considering the structure, the legal form, the contractual arrangement and other facts and circumstances.

The classification analysis can be summarised in a decision tree as follows:

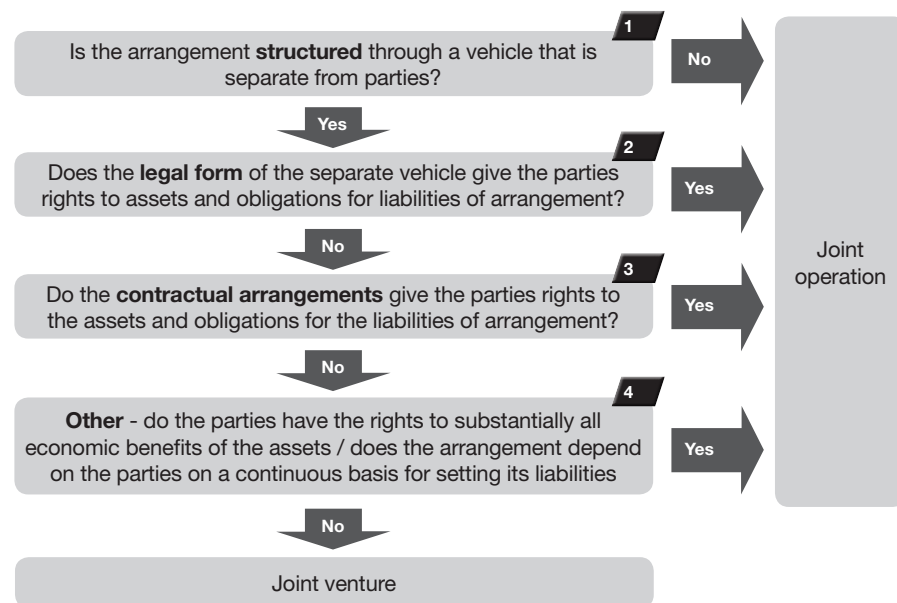


Exhibit 10.9: The classification analysis of joint arrangement

We briefly summarise the steps in the classification analysis of joint arrangement as follows.

1. A joint arrangement not structured through a separate vehicle should be classified as a joint operation. If there is a separate vehicle, the remaining tests would apply.
2. If the legal form of the separate vehicle does not confer separation between the parties and the separate vehicle, i.e. the assets and liabilities placed in a separate vehicle are parties' assets and liabilities, then the joint venture is a joint operation. Otherwise, the remaining tests apply.
3. When a contractual arrangement specifies that the parties have rights to assets and obligations for liabilities relating to the arrangement, then the arrangement is a joint operation. Otherwise, the last test applies.
4. The test at this step of the analysis is to identify whether, in spite of the legal form and contractual arrangement indicating that the arrangement is a joint venture, other facts and circumstances give the parties rights to substantially all economic benefits relating to the arrangement; and cause the arrangement to depend on the parties on a continuous basis for settling its liabilities and therefore the arrangement is a joint operation. When the activities of an arrangement are designed to provide output to the parties and the arrangement is limited in its ability to sell to third parties, this indicates that the parties have rights to substantially all the economic benefits of the arrangement's assets. When the parties are substantially the only source of cash flows contributing to the arrangement's operations, this indicates that the parties have an obligation for the liabilities relating to the arrangement.

How this could affect you

We set out in the table below the requirements that have been modified in the new joint control model and that are expected to have an impact on the preparers and users of the financial statements:

Key changes	Potential impacts
The structure of the joint arrangement is no longer the main factor in determining the accounting	It is expected that in practice many, but not all, jointly controlled entities under FRS 31 will be classified as joint ventures under FRS 111. All joint arrangements would need to be re-assessed on transition to FRS 111 as there may be a change in classification. The new classification framework is expected to be an area of judgement that requires careful consideration in practice.
A single method of accounting	<p>The transition from proportionate consolidation to the equity method will affect virtually all of an entity's financial statements line items, notably decreasing revenue, gross assets and liabilities. There may also be some consequential effects e.g. when a venture has hedged a joint venture's asset or liability, it may not be possible to apply hedge accounting once equity accounting is applied. Similarly, a venturer's interest expense may no longer be capitalised into a joint venture's asset.</p> <p>The extractive and real estate industries are likely to be particularly affected by the new requirements because of the prevalence and complexity of the joint arrangements used</p> <p>As a consequence, entities may need to:</p> <ul style="list-style-type: none">• Consider the effect on existing contracts• Communicate the expected effects of transition to shareholders, including managing analysts' expectations.

Exhibit 10.10: The key changes of joint control model

Practical examples

Example 4 – Classification of a joint arrangement

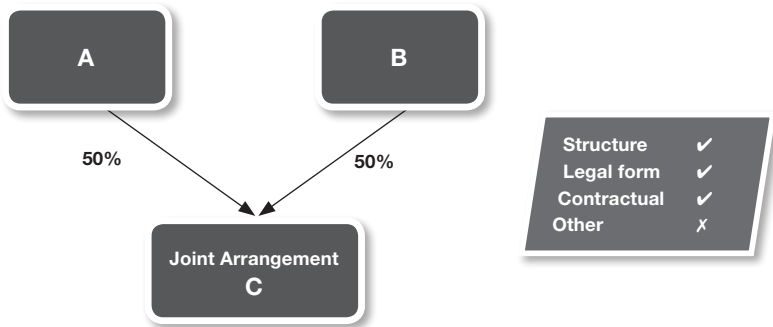


Exhibit 10.11: Example of joint arrangement classification

Two entities, A and B structure a joint arrangement as an incorporated entity C, in which each party has 50 per cent ownership interest. The purpose of the arrangement is to manufacture materials required by the entities for their own, individual manufacturing processes and in accordance to their quality and quantity specifications. The legal form indicates that the assets and liabilities of the joint arrangement are those of entity C. The contractual arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of entity C. However, the entities agreed to purchase all the output of C in a ratio of 50:50. Entity C cannot sell any output to third parties, unless it is approved by the entities and the sales to third parties are expected to be uncommon. The price for the output is set by both entities at a level designated to cover the costs of production and administrative expenses of C. The other facts indicate that the arrangement is a joint operation, because the obligation of the entities to purchase all the output indicates that the parties have an obligation to fund the settlement of liabilities of C. The fact that the parties have the right to all the outputs of C indicates that the parties have rights to all the economic benefits of C and the rights to net assets are not that relevant.

Disclosures

Overview of the new disclosure requirements

FRS 112 is a consolidated disclosure standard requiring a wide range of disclosures about an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated 'structured entities'.

In the context of FRS 112, interests in other entities are contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity. These interests may for example take the form of equity or debt instruments, but can also comprise other forms of involvement, such as the provision of funding, liquidity support, credit enhancement and/or guarantees. However, FRS 112 confirms that an interest in another entity does not exist solely as a result of a typical customer-supplier relationship.

The disclosures under FRS 112 may be aggregated for interests in similar entities, with the method of aggregation being disclosed.

A structured entity is defined in FRS 112 as an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity. An example of a structured entity would be when voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

The objective of FRS 112 is to require the disclosure of information that enables users of financial statements to evaluate:

- the nature of, and risks associated with, its interests in other entities; and
- the effects of those interests on its financial position, financial performance and cash flows.

The following table sets out a high-level summary of the main disclosure requirements:

Area	Main disclosure requirements
Significant judgements and assumptions	<p>An entity discloses information about significant judgements and assumptions it has made in determining:</p> <ul style="list-style-type: none"> • that it controls another entity • that it has joint control of an arrangement or significant influence over another entity • the type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle
Interests in subsidiaries	<p>An entity shall disclose information that enables users of its consolidated financial statements to:</p> <ul style="list-style-type: none"> • understand the composition of the group • understand the interest that non-controlling interests have in the group's activities and cash flows • evaluate the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group • evaluate the nature of, and changes in, the risks associated with its interests in consolidated structured entities • evaluate the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control • evaluate the consequences of losing control of a subsidiary during the reporting period.

Area	Main disclosure requirements
Interests in unconsolidated subsidiaries	<p>Where an entity is an investment entity, FRS 112 requires additional disclosure, including:</p> <ul style="list-style-type: none"> the fact the entity is an investment entity information about significant judgements and assumptions it has made in determining that it is an investment entity details of subsidiaries that have not been consolidated (name, place of business, ownership interests held) details of the relationship and certain transactions between the investment entity and the subsidiary (e.g. restrictions on transfer of funds, commitments, support arrangements, contractual arrangements) information where an entity becomes, or ceases to be, an investment entity
Interests in joint arrangements and associates	<p>An entity shall disclose information that enables users of its financial statements to evaluate:</p> <ul style="list-style-type: none"> the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates the nature of, and changes in, the risks associated with its interests in joint ventures and associates
Interests in un-consolidated structured entities	<p>An entity shall disclose information that enables users of its financial statements to:</p> <ul style="list-style-type: none"> understand the nature and extent of its interests in unconsolidated structured entities; evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

Exhibit 10.12: Summary of the main disclosure requirements

How this could affect you

The disclosure requirements are extensive. FRS 112 has the potential to broaden the transactions and relationships to which the disclosures may apply due to a wide definition of 'interests'. The disclosure requirements apply to an entity's involvement with all unconsolidated structured entities, subject to materiality considerations, i.e. there is no 'grandfathering' of interests held or entities sponsored in the past. Significant judgement is involved, particularly for involvement with a structured entity. The new disclosure requirements may require some entities to develop new systems and/or controls to track interests in structured entities and interactions with those entities.

Conclusion

Overall, the implementation of the new suite of consolidation standards may take significant time to assess the impact and will require significant judgements, in several respects.

Robust accounting policies will need to be developed and consistently applied, performance metrics and debt covenants may need to be altered. Modifications to systems and processes may be required. The market will need to be informed. Any changes to contractual arrangements to achieve certain outcomes will need time.

There is an urgency to act, as there is much to do, but only limited time to ensure a smooth transition.

References and further reading

KPMG (2012), "IFRS Practice Issues: Applying the consolidation model to fund managers" [URL](#)

KPMG (2013), "IFRS Practice Issues: Adopting the consolidation suite of standards" [URL](#)

Chapter 11

The New Wave to Financial Instruments – IFRS 9

Chen Voon Hoe & Senthilnathan Sampath, PricewaterhouseCoopers

Introduction

During the financial crisis of 2007-08, the G20 tasked global accounting standard setters to work intensively towards the objective of creating a single high-quality global standard. As a response to this request, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) began to work together on the development of new financial instruments standards. The IASB decided to accelerate its project to replace IAS 39 with IFRS 9, and sub-divide it into three main phases: classification and measurement; impairment; and hedging. Macro hedging is being considered as a separate project.

The IASB completed the first phase of this project (classification and measurement) for financial assets in November 2009 and for financial liabilities in November 2010. In late 2011, the IASB decided to consider limited amendments to the classification and measurement model in IFRS 9, and published the exposure draft (ED) on these limited amendments at the end of November 2012.

As part of this project, the IASB issued its first impairment ED in 2009. At that time, the IASB proposed that an entity should measure amortised cost at the expected cash flows discounted at the original credit-adjusted effective interest rate. As a result, interest revenue would be recorded net of the initial expected credit losses. Although constituents supported the concept, they raised serious concerns about its operationality. The IASB subsequently developed the three-bucket model and the feedback supported a model that differentiates between financial instruments that have suffered a significant deterioration in credit quality since initial recognition and financial instruments that have not. Based on the feedback received, the IASB further modified the three-bucket model proposals, in particular, the requirements as to when a financial instrument's loss allowance should be measured at an amount equal to lifetime expected credit losses.

For the third part of the project, hedge accounting, the IASB has issued a review draft (RD) that details the new hedge accounting requirements. The RD relaxes the requirements for hedge effectiveness assessment and consequently the eligibility for hedge accounting. Under IAS 39 today, the hedge must both be expected to be highly effective (a prospective test) and demonstrated to have actually been highly effective (a retrospective test), with 'highly effective' defined as a 'bright line' quantitative test of 80-125 per cent. The RD replaces this with a requirement for there to be an economic relationship between the hedged item and hedging instrument, and for the hedged ratio of the hedging relationship to be the same as the quantity of the hedged item and hedging instrument that the entity actually uses for its risk management purposes. An entity is still required to prepare contemporaneous documentation to support hedge accounting. In addition, hedge ineffectiveness must still be measured and reported in the profit or loss.

In summary, the phases and status of the project is shown in the table below:

Phase	Status
Classification and measurement	Financial assets – IFRS 9 published November 2009. Limited modifications to IFRS 9 exposure draft published November 2012. Financial liabilities – IFRS 9 published October 2010.
Impairment	Exposure draft published March 2013.
Hedge accounting	General hedging final standard expected Q3 2013. Macro hedging discussion paper Q3 2013.

Exhibit 11.1: IFRS 9 timeline

The IASB previously decided that the requirements of IFRS 9 would be effective from the start of 2015. But the ED contains a consequential amendment to IFRS 9 that removes the effective date of 1 January 2015. The board is seeking views on the lead time that entities would need to implement the impairment proposals.

In addition, the EU has not yet endorsed IFRS 9, thereby precluding IFRS reporting entities within the EU from adopting the standard early. The EU has indicated that it will only make a decision on endorsement once the entire financial instruments guidance has been finalised, excluding macro hedging. A similar approach has been taken by Accounting Standards Council of Singapore.

Classification and measurement

IFRS 9's objective is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of amounts, timing and uncertainty of the entity's future cash flows.

IFRS 9 has to be applied by all entities preparing their financial statements in accordance with IFRS and to all types of financial assets and financial liabilities within the IAS 39's scope, including derivatives. Essentially any financial assets and financial liabilities that are currently accounted for under IAS 39 will fall within the IFRS 9's scope.

IFRS 9 replaces the multiple classification and measurement models for financial assets in IAS 39 with a model that currently has only two classification categories: amortised cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets.

IFRS 9 removes existing IAS 39 categories, notably the held-to-maturity and available-for-sale categories and the tainting rules associated with the former, and the requirement to separate embedded derivatives from financial asset hosts. Hybrid financial asset contract now needs to be classified in its entirety at either amortised cost or fair value.

Initial recognition

Consistent with IAS 39, all financial instruments in IFRS 9 are to be initially recognised at fair value, plus or minus – in the case of a financial instrument that is not at fair value through profit or loss – transaction costs that are directly attributable to the acquisition or issue of the financial instrument.

Classification and measurement model – debt investments

If the financial asset is a debt instrument, entities should consider whether both the following criteria are met:

- Business model test: The objective of the entity's business model is to hold the asset to collect the contractual cash flows (the HTC test);
- Contractual cash flows test: The asset's contractual cash flows represent solely payments of principal and interest (the SPPI test).

If both these tests are met, the financial asset falls into the amortised cost measurement category. If the financial asset does not pass both tests, it is measured at fair value through profit or loss. Fair value option (i.e. designated as fair value through profit or loss) is retained for elimination of an accounting mismatch.

In the new ED of limited modifications to classification and measurement, a third category is introduced for debt investments: fair value through other comprehensive income. This decision was a key step towards convergence with the FASB and was considered to alleviate some concerns raised by certain financial institutions.

IASB has now defined the business models for classification and measurement of debt investments as follows:

- Amortised cost: consists of debt investments in order to collect the contractual cash flows.
- Fair value through other comprehensive income (FV-OCI): consists of debt investments which are managed both in order to hold to collect contractual cash flows and to sell them.
- Fair value through profit or loss (FV-PL): consists of debt investments that are not measured at amortised cost or at FV-OCI.

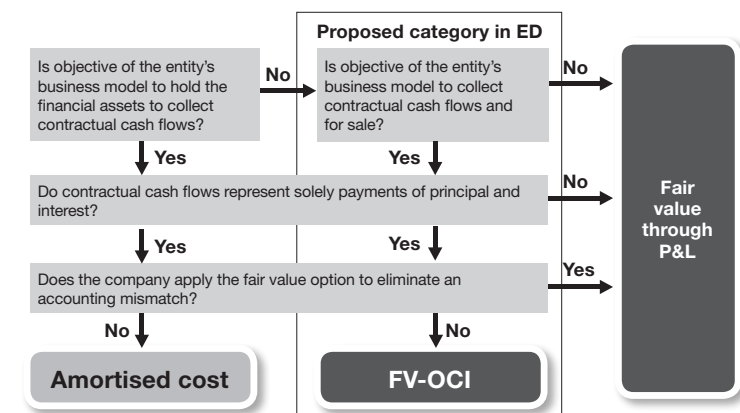


Exhibit 11.2: Summary of the model for debt instruments in the ED

The FV-OCI category is intended to acknowledge the practical reality that entities may invest in debt instruments to generate yield but may also sell if the price is considered advantageous or it is necessary to periodically adjust or rebalance the entity's net risk, duration or liquidity position. Entities will need to carefully assess the overall business objective to determine whether their portfolios of financial assets are more aligned with this new FV-OCI business model (hold to collect and to sell) or that of an amortised cost business model (hold to collect) or whether they fall in the residual FV-PL category. Business models for such portfolios can vary widely and hence judgement will be needed to evaluate the factors for each individual portfolio.

Business model test

IFRS 9 requires that all financial assets are subsequently measured at amortised cost or fair value based on the entity's business model for managing the financial assets. If the entity's objective is to hold the asset to collect the contractual cash flows, then it will meet the first criterion to qualify for amortised cost. Some sales or transfers of financial instruments before maturity may not be inconsistent with such a business model.

The 'tainting' concept does not exist in IFRS 9 – that is, sales of 'held to maturity' assets under IAS 39 before maturity jeopardise amortised cost accounting for the entire portfolio. However, sales of financial assets prior to their maturity will impact the determination of the business model. It is therefore important to understand the nature, frequency and pattern of sales of financial assets in order to determine the business model and to assess whether sales are 'infrequent'.

If more than an infrequent number of sales are made out of a portfolio, management should assess whether and how such sales are consistent with an objective of holding to collect contractual cash flows. There is no bright line for how many sales constitute 'infrequent'; management will need to use judgement based on the facts and circumstances to make its assessment.

In most cases, questions were raised about what qualified in the amortised cost category and when sales would not prevent the portfolio from being held to collect cash flows. The IASB has provided examples of factors to consider when assessing the business model for the portfolio are:

- The way the assets are managed.
- How performance is evaluated.
- How management is compensated.
- The historical frequency, timing and volume of sales.
- The reason for the sales (such as credit deterioration).
- Expectation about the future sales activity in the future.

Entities need to be aware that 'significance' of sales should not be measured with regard to the effect on profit or loss. For example, the entity could sell one financial asset that results in a large gain and this would not necessarily fail the business model test due to its significant effect on profit or loss unless it was the entity's business model to sell financial assets to maximise returns. Furthermore, the ED indicates that significance of sales should be considered in the aggregate rather than individually.

Entities also need to apply judgement to determine at what level the business model condition is applied. That determination should be made on the basis of how an entity manages its business; it is not made at the level of an individual asset. The entity's business model is not therefore a choice and does not depend on management's intentions for an individual instrument; it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management.

While the FV-PL category is generally considered the ‘residual’ category, it is expected that the following financial assets would be included in FV-PL:

- those held for trading;
- those managed on a fair value basis to maximise cash flows through the sale of assets;
- those where the collection of cash flows is not integral to achieving the business model objective (but only incidental to it) as well as; or
- those that fail the SPPI test.

The key challenge is to distinguish between FV-OCI and FV-PL; particularly as the ED refers to either “maximising returns” or “maximising cash flows”, respectively, to describe the business activities in these two categories. However, the key to classification is whether the entity has both the objective to collect cash flows and to sell in order to qualify for FV-OCI versus simply the primary objective under the FV-PL category to maximise cash flows through selling financial assets such that collecting cash flows is only incidental. For example, collecting cash flows might be incidental where the entity holds the financial assets for a period of time due to market conditions with a view to earning a more favourable price in the future.

Contractual cash flows that are solely payments of principal and interest

The other condition that must be met in order for a financial asset to be eligible for amortised cost accounting is that the contractual terms of the financial asset give rise on specified dates to cash flows that are ‘solely payments of principal and interest on the principal amount outstanding’. In this case, interest is defined as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.

In order to meet this condition, there can be no leverage of the contractual cash flows. Leverage increases the variability of the contractual cash flows, with the result that they do not have the economic characteristics of interest.

However, unlike leverage, certain contractual provisions will not cause the ‘solely payments of principal and interest’ test to be failed. Contractual provisions that permit the issuer or holder to extend the contractual term of a debt instrument are also regarded as being solely payments of principal and interest, provided that, during the term of the extension, the contractual cash flows are solely payments of principal and interest as well (for example, the interest rate does not step up to some leveraged multiple of LIBOR) and the provision is not contingent on future events.

The following are examples of contractual cash flows that are not solely payments of principal and interest:

- Bonds where the amount of interest varies inversely to a market rate of interest (inverse floaters).
- Links to equity index, borrower’s net income or other non-financial variables.
- Convertible bond (from the holder’s perspective).

If a contractual cash flow characteristic is not genuine, it does not affect the financial asset’s classification. In this context, ‘not genuine’ means the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

Equity instruments

Investments in equity instruments (that meet the definition of equity as defined in IAS 32 from the perspective of the issuer) are always measured at fair value. Equity instruments that are held for trading are required to be classified as at fair value through profit or loss. For all other equities, management has the ability to make an irrevocable election on initial recognition, on an instrument-by-instrument basis, to present changes in fair value in other comprehensive income (OCI) rather than profit or loss. If this election is made, all fair value changes, excluding dividends that are a return on investment, will be reported in OCI. There is no recycling of amounts from OCI to profit and loss – for example, on sale of an equity investment – nor are there any impairment requirements. However, the entity may transfer the cumulative gain or loss within equity.

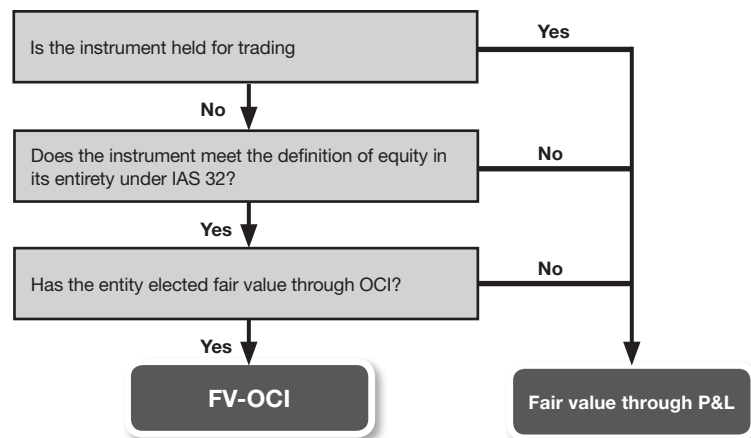


Exhibit 11.3: Summary of the model for equity instruments in the exposure draft

The standard removes the requirement in IAS 39 to measure unquoted equity investments at cost when the fair value cannot be determined reliably. However, it indicates that, in limited circumstances, cost may be an appropriate estimate of fair value – for example, when insufficient more recent information is available from which to determine fair value; or when there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

IFRS 9 includes indicators of when cost might not be representative of fair value. These are:

- A significant change in the investee's performance compared with budgets, plans or milestones.
- Changes in expectation that the investee's technical product milestones will be achieved.
- A significant change in the market for the investee's equity or its products or potential products.
- A significant change in the global economy or the economic environment in which the investee operates.
- A significant change in the performance of comparable entities or in the valuations implied by the overall market.
- Internal matters of the investee such as fraud, commercial disputes, litigation or changes in management or strategy.
- Evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity) or by transfers of equity instruments between third parties.

Given the indicators above, it is not expected that cost will be representative of fair value for an extended period of time. Entities may therefore need to develop an estimate of fair value for their unquoted equity instruments.

Classification and measurement – financial liabilities

The classification and measurement of financial liabilities under IFRS 9 remains the same except where an entity has chosen to measure a liability at fair value through profit or loss. There continue to be two measurement categories for financial liabilities: fair value and amortised cost. Certain liabilities are required to be at fair value through profit or loss, such as liabilities held for trading and derivatives. Other liabilities are measured at amortised cost, unless the liability has embedded derivatives or the entity elects the fair value option.

Financial liabilities that are required to be measured at fair value through profit or loss (as distinct from those that the entity has chosen to measure at fair value through profit or loss) continue to have all fair value movements recognised in profit or loss with no transfer to OCI. This includes all derivatives (such as foreign currency forwards or interest rate swaps), or an entity's own liabilities that it considers as 'trading'.

The new part of IFRS 9 changes the accounting for financial liabilities that an entity chooses to account for at fair value through profit or loss, using the fair value option. For such liabilities, changes in fair value related to changes in own credit risk are presented separately in OCI.

Amounts in OCI relating to own credit are not recycled to the income statement even when the liability is derecognised and the amounts are realised. However, the standard does allow transfers within equity.

The treatment of own credit risk presented in OCI is consistent with the requirements in IFRS 9 that prohibit recycling to profit or loss for investments in equity instruments that are measured at fair value with changes presented in OCI. However, entities that wish to transfer realised balances to retained earnings, for example, could do so, as transfers within equity are permitted.

Transition

IFRS 9 allows entities to early adopt the standard. However, as part of the changes introduced in the limited amendments project, the IASB proposes that entities could not early adopt previous versions of IFRS 9 once the IASB has completed all phases of the project (though the proposal allows for a six month window to still apply earlier phases once the revised IFRS 9 is finalised). Completion of the standard includes these classification and measurement amendments, impairment and hedging (excluding macro hedging).

IFRS 9 requires retrospective application based on an assessment at the date of initial application. The IASB's targeted amendments to IFRS 9 contain specific transition proposals for companies that have already early adopted.

Amortised cost and impairment

Background

IASB issued the exposure draft (ED) on impairment of financial instruments on 7 March 2013 with the deadline for comment period ending on 5 July 2013.

The ED outlines an expected loss model that will replace the current incurred loss model of IAS 39 Financial Instruments: Recognition and Measurement. It seeks to address the criticisms of the incurred loss model and, in particular, that it caused impairment losses to be recognised 'too little and too late'. It is expected that impairment losses will not only be larger but will also be recognised earlier.

The proposal does not specify its effective date, but is seeking comments on the appropriate mandatory effective date for all phases of IFRS 9.

Scope of the proposed model

The proposed model should be applied to:

- Financial assets measured at amortised cost under IFRS 9;
- Financial assets measured at fair value through other comprehensive income under the ED 'Classification and measurement: Limited amendments to IFRS 9';
- Loan commitments when there is a present legal obligation to extend credit, except for loan commitments accounted for at fair value through profit or loss under IFRS 9;
- Financial guarantee contracts within the scope of IFRS 9 and that are not accounted for at fair value through profit or loss; and
- Lease receivables within the scope of *IAS 17 Leases*.

General model

Under the proposed model, an entity should recognise an impairment loss equal to 12-month expected credit loss; or if the credit risk on the financial instrument has increased significantly since initial recognition, it should recognise a lifetime expected credit loss.

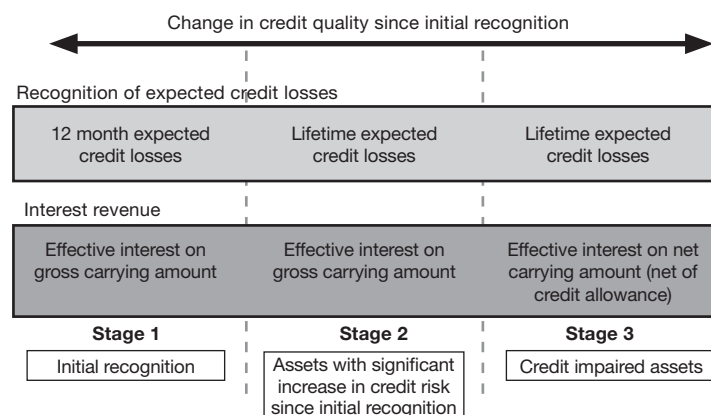


Exhibit 11.4: The general model

The ED proposes a model that reflects the general pattern of deterioration in credit quality of a financial instrument. As a result, the recognition of full lifetime expected credit losses does not occur on initial recognition. The loss allowance is recorded at the 12-month expected credit loss at initial recognition and continues to be measured on this basis until a trigger is met (that is, a significant increase in credit risk). Once the trigger is met, the loss allowance is measured based on lifetime expected credit losses.

Assessment of change in credit risk

The IASB's dual measurement model requires an entity to assess the point at which it is required to transfer a financial instrument from the 12-month expected credit loss measurement to the lifetime expected credit loss measurement. Under the ED proposals, this transfer point is met when the credit risk of a financial instrument has increased significantly since initial recognition. Where credit risk subsequently reduces to a point where there is no longer a significant increase in credit risk since initial recognition an entity should transfer from the lifetime expected credit loss measurement to the 12-month expected credit loss measurement.

The IASB has not defined the term 'significant' when assessing the change in credit risk or specified the amount of change in probability of a default that would require the recognition of lifetime expected credit losses. Although illustrative examples are provided in the ED, judgement will be required when applying the model.

When considering the magnitude of a change in credit risk, entities should use probabilities of a default rather than the change in expected credit losses. When performing this assessment, an entity should compare the probability of a default on the instrument as at the reporting date with the probability of a default on the instrument as at initial recognition. Generally speaking, the lifetime probability of a default (over the remaining life of the instrument) should be used. But, as a practical expedient, in order to use other information used by an entity (that is, for regulatory purposes), a 12-month probability of a default can be used if it would not lead to a different assessment.

When determining whether lifetime expected losses should be recognised, an entity should consider the best information available, including actual and expected changes in external market indicators, internal factors and borrower-specific information. Where more forward-looking information is not available, delinquency data can be used as a basis for the assessment. But, in this case, there is a rebuttable presumption that lifetime expected losses should be provided for if contractual cash flows are 30 days past due.

When determining whether the credit risk on an instrument has increased significantly, an entity should consider the best information available, including actual and expected changes in external market indicators, internal factors and borrower-specific information. The factors include: changes in external market indicators (such as credit spreads); changes in current and expected external and internal credit ratings; changes in internal price indicators for credit; existing or forecast changes in business, financial or economic conditions that are expected to cause a change in a borrower's ability to meet its debt obligations; and changes in operating results of the borrower. The information used should not only reflect past events and current conditions, but should also include reasonable and supportable forecasts of future events and economic conditions.

As an exception to the general model, if the credit risk of a financial instrument is low at the reporting date, irrespective of the change in credit risk, the entity should not transfer from 12-month expected credit losses to full lifetime expected credit losses. We understand that the IASB's intention here was to capture instruments with a credit risk equivalent to 'investment grade'. This exception to the general model was introduced to make the model more cost effective. This eliminates the need for tracking the change in credit quality for an instrument with low credit risk.

However, with the exception of financial instruments with low credit risk at the reporting date, an entity will have the challenge to track credit quality at inception and compare it to the credit quality at the reporting date. This is likely to require changes to existing systems, but entities might be able to use their current risk management practices.

Discount rate

When calculating the expected credit loss (regardless of whether it is the 12-month or the lifetime expected credit loss), the time value of money must be considered. The ED requires an entity to determine the appropriate discount rate, which could be any discount rate between the risk-free rate and the effective interest rate. This rate can be a current rate (for example, the prevailing risk-free rate at each reporting period). But, once there is objective

evidence of impairment (that is, the asset is impaired under the current rules of IAS 39) at reporting date, an entity shall measure the expected credit losses as the difference between the asset's amortised cost and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate.

One of the exceptions to the rule is for undrawn loan commitments and financial guarantees. For loan commitments and financial guarantees, the discount rate should reflect the current market assessment of the time value of money and the risks that are specific to the cash flows.

Another exception is for purchased or originated credit-impaired assets, where expected credit losses should be discounted using their specific credit-adjusted effective interest rate.

Interest revenue

Interest revenue is calculated using the effective interest method on an asset's gross carrying amount. Similar to today, it should be presented as a separate line item in the statement of profit or loss and other comprehensive income. But, once there is objective evidence of impairment (that is, the asset is impaired under the current rules of IAS 39), interest is calculated on the carrying amount, net of the expected credit loss allowance.

The IASB believes that the basis for interest calculation needs to be changed at this point to avoid increasing the gross carrying amount above the amount that will be collected by the entity.

Loan commitments and financial guarantees

For loan commitments and financial guarantees that are in scope, the expected drawdown for provisioning purposes should be determined over the period that an entity has a contractual obligation to extend credit. This means that, if an undrawn facility is immediately revocable, no provision for expected credit losses will be recognised, even if an entity expects that the facility will not be revoked in time to prevent a credit loss.

As mentioned previously, when calculating the expected credit losses, an entity does not have the same choice over selecting the discount rate. The discount rate for assessing the expected credit losses on loan commitments and financial guarantees should reflect the current market assessment of the time value of money and the risks that are specific to the cash flows.

Entities may need to take note that the IASB's proposed model for loan commitments is different from current practice under IFRS. Currently, entities assess impairment for credit risk management purposes based on the behavioural expectations of an entity (which can extend beyond the contractual period). So, the IASB ED's requirements for measurement to reflect the contractual obligation could require entities to change their current assessment, which might result in a decrease in the level of provisions (as compared to current practice).

Purchased or originated credit-impaired assets

The general impairment model does not apply for purchased or originated credit-impaired assets. An asset is considered credit-impaired on purchase or origination if there is objective evidence of impairment (as set out in IAS 39) at the point of initial recognition of the asset (for instance, if it is acquired at a deep discount).

For such assets, impairment is determined based on full lifetime expected credit losses on initial recognition. But the lifetime expected credit losses are included in the estimated cash flows when calculating the effective interest rate on initial recognition. The effective interest rate for interest recognition throughout the life of the asset is a credit-adjusted effective interest rate. As a result, no loss allowance is recognised on initial recognition.

Any subsequent changes in lifetime expected credit losses, both positive and negative, will be recognised immediately in profit or loss.

Trade and lease receivables

The proposal includes a simplified approach for trade and lease receivables. An entity should measure the loss allowance at an amount equal to the lifetime expected credit losses for short-term trade receivables resulting from transactions within the scope of IAS 18, 'Revenue'. The ED also proposes to amend IFRS 9 to initially measure trade receivables that have no significant financing component at their transaction price (rather than at fair value, as currently required) when the new Revenue Standard is published.

For long-term trade receivables and for lease receivables under IAS 17, an entity has an accounting policy choice between the general model and the model applicable for short-term trade receivables.

The use of a provision matrix is allowed if it is appropriately adjusted to reflect current conditions and forecasts of future conditions.

The simplified model for short-term trade receivables represents a change from the current practice under IAS 39 where an impairment loss is frequently recognised when the trade receivable becomes past due. The IASB included the simplified model of the recognition of the lifetime expected credit loss allowance on day one to reduce the cost of implementation for short-term trade receivables.

Transition and effective date

The ED is to be applied retrospectively, but restatement of comparatives is not required. But entities are permitted to restate comparatives if they can do so without the use of hindsight. If an entity does not restate comparatives, it should adjust the opening balance of its retained earnings for the effect of applying the proposals in the year of initial application.

Conclusion

Entities need to consider whether they are able and wish to adopt particular standards early to capitalise on the transitional provisions in the standards. Entities will need to plan and prepare carefully for the transition to the new IFRS requirements. Some factors to be considered are listed below:

- Developing a plan/process to evaluate and incorporate changes.
- Educating the various business divisions and evaluating potential impact.
- Evaluating between embedding changes into systems and processes and adoption of interim solutions.
- Availability of data requirements.
- Scalability of systems and processes to accommodate further changes in IFRS over next few years.
- Adequacy of resources required for implementation.
- Interaction between IFRS adoption and other finance projects, for example, standardisation and automation of finance processes.

Keep up to date with the developments. Be prepared. Start now.

References and further reading

PricewaterhouseCoopers (2011), "Practical guide on financial instrument accounting: IFRS 9" [URL](#)

PricewaterhouseCoopers (2013a), "IASB publishes exposure draft on impairment of financial instruments" [URL](#)

PricewaterhouseCoopers (2013b), "Updated publication: Essential guide to international accounting - IFRS summaries" [URL](#)

Chapter 12 Annual Improvements Project and Revenue

Shariq Barmaky, Deloitte & Touche LLP Singapore

Introduction

This chapter provides a brief outline of the current status of IASB's annual improvements project and the implementation issues relating to the upcoming new standard on revenue accounting.

Part 1 – Overall IFRS improvements project

Background

The IASB's annual improvements project provides a streamlined process for dealing efficiently with a collection of amendments to IFRSs. The primary objective of the process is to enhance the quality of standards, by amending existing IFRSs to clarify guidance and wording, or to correct for relatively minor unintended consequences, conflicts or oversights. Amendments are made through the annual improvements process when the amendment is considered non-urgent but necessary.

Each year the IASB discusses and decides upon proposed improvements to IFRSs as they have arisen throughout the year. Issues dealt with in this process arise from matters raised by the IFRS Interpretations Committee and suggestions from staff or practitioners.

Annual Improvements Project: 2009-2011 Cycle

The IASB published Annual Improvements to IFRSs (2009-2011 Cycle) on 17 May 2012. A summary of the key amendments is set out below. Unless otherwise stated, the effective dates are for annual periods beginning on or after 1 January 2013.

IFRS 1 First-time Adoption of International Financial Reporting Standards

Repeated application of IFRS 1

The amendments apply to an entity that had applied IFRSs in a previous reporting period, but whose most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with IFRSs. For example, assume that an entity already applied IFRS 1 when it first prepared IFRS financial statements in prior periods, but for its most recent financial statements, it may have decided to prepare its financial statements in another GAAP instead of IFRS. Subsequently, if it decides to prepare its financial statements in IFRS, the amendments clarify that an entity may repeat the application of IFRS 1 even if the entity had applied IFRS 1 in the past.

An entity that does not elect to apply IFRS 1 must apply IFRSs retrospectively as if there was no interruption.

An entity should disclose the reason it stopped applying IFRSs, the reason it is resuming the application of IFRSs, and the reason it has elected not to apply IFRS 1, if applicable.

Borrowing costs

The amendments clarify that borrowing costs capitalised under previous GAAP before the date of transition to IFRSs may be carried forward without adjustment to the amount previously capitalised at the transition date.

Borrowing costs incurred on or after the date of transition to IFRSs that relate to qualifying assets under construction at the date of transition should be accounted for in accordance with *IAS 23 Borrowing Costs*.

IAS 1 Presentation of Financial Statements

Clarification of the requirements for comparative information

The amendments clarify that additional comparative information is not necessary for periods beyond the minimum comparative financial statement requirements of IAS 1. If additional comparative information is provided, the information should be presented in accordance with IFRSs, including disclosure of comparative notes for any additional statements included beyond the minimum comparative financial statement requirements.

For example, an entity may present a third statement of profit or loss and other comprehensive income (thereby presenting the current period, the preceding period and one additional comparative period). However, the entity is not required to present a third statement of financial position, a third statement of cash flows or a third statement of changes in equity (ie an additional financial statement comparative). The entity is required to present, in the notes to the financial statements, the comparative information related to that additional statement of profit or loss and other comprehensive income.

In addition, an entity that changes accounting policies retrospectively, or makes a retrospective restatement or reclassification which has a material effect on the information in the statement of financial position at the beginning of the preceding period would present the statement of financial position at the end of the current period and the beginning and end of the preceding period. Other than disclosure of certain specified information required by *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors* (e.g. information on nature and amounts of misstatement), related notes are not required to accompany the opening statement of financial position as at the beginning of the preceding period.

IAS 16 Property, Plant and Equipment*Classification of servicing equipment*

This amendment clarifies the treatment of spare parts, stand-by equipment and servicing equipment. These should be classified as property, plant and equipment when they meet the definition of property, plant and equipment in IAS 16 and as inventory otherwise.

IAS 32 Financial Instruments: Presentation*Tax effect of distribution to holders of equity instruments*

This amendment now results in consistency between IAS 32 and IAS 12 *Income Taxes*. It clarifies that income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction should be accounted for in accordance with IAS 12 instead of IAS 32.

IAS 34 Interim Financial Reporting*Interim financial reporting and segment information for total assets and liabilities*

This amendment now results in consistency between IFRS 8 *Operating Segments* and IAS 34. The total assets and total liabilities for a particular reportable segment would be separately disclosed in interim financial reporting only when the amounts are regularly provided to the chief operating decision maker and there has been a material change from the amounts disclosed in the last annual financial statements for that reportable segment.

Exhibit 12.1: Annual improvements project 2009-2011 cycle

Annual Improvements Project: 2010-2012 Cycle

The IASB published Exposure Draft ED/2012/1 *Annual Improvements to IFRSs (2010-2012 Cycle)* on 3 May 2012. The comment period on the proposals ended on 5 September 2012. At the time of writing, finalised amendments are expected in the third quarter of 2013.

A summary of the key amendments is set out in the table below. Unless otherwise stated, the proposed effective dates are for annual periods beginning on or after 1 January 2014.

IFRS 2 Share-based Payment*Definition of 'vesting condition'*

The proposals clarify the definitions of "performance conditions" and "service conditions". The proposals also address the following concerns relating to these definitions:

- the correlation of the employee's responsibility and the performance target;
- whether a share market index target may constitute a performance condition or a non-vesting condition;
- whether a performance target that refers to a longer period than the required service period may constitute a performance condition; and
- whether the employee's failure to complete a required service period is considered to be a failure to satisfy a service condition.

IFRS 3 Business Combinations*Accounting for contingent consideration in a business combination*

The proposals clarify that:

- Classification of contingent consideration in a business combination is assessed either as a liability or an equity instrument is based solely on the requirements of *IAS 32 Financial Instruments: Presentation*. Currently, IFRS 3 refers to not only IAS 32 but also to “other applicable IFRSs” – the latter reference is proposed to be deleted as it is unclear as to when it can ever be applicable; and
- Contingent consideration in a business combination that is not classified as an equity instrument is subsequently measured at fair value, with the corresponding gain or loss recognised either in profit or loss or other comprehensive income in accordance with *IFRS 9 Financial Instruments*.

The proposed effective date for the amendment is for annual periods beginning on or after 1 January 2015.

IFRS 8 Operating Segments*Aggregation of operating segments*

The proposals require entities to disclose the judgements made in identifying its reportable segments when operating segments have been aggregated, including a description of the operating segments that have been aggregated.

Reconciliation of the total of the reportable segments' assets to the entity's assets

It is proposed that a reconciliation between the total reportable segments' assets and the entity's assets be disclosed if segment assets are regularly provided to the chief operating decision maker.

IFRS 13 Fair Value Measurement*Short-term receivables and payables*

The proposal clarifies that short-term receivables and payables with no stated interest rate may be measured at invoiced amounts without discounting. The consequential amendments to *IAS 39 Financial Instruments: Recognition and Measurement* from IFRS 13 appeared to have indicated otherwise.

IAS 1 Presentation of Financial Statements*Current/non-current classification of liabilities*

The proposal clarifies that for an entity to classify a liability as non-current, the entity must expect to and is able to refinance or roll over the obligation for at least twelve months after the reporting period under an existing loan facility with the lender on the same or similar terms. If the terms of any rollover rights are substantially different from the original terms, then the classification as non-current is inappropriate.

IAS 7 Statement of Cash Flows*Interest paid that is capitalised*

The proposal clarifies that the classification of interest paid will follow the classification of the underlying asset to which those payments were capitalised.

IAS 12 Income Taxes*Recognition of deferred tax assets for unrealised losses*

The proposals clarify that:

- an entity assesses recognition of a deferred tax asset in combination with other deferred tax assets if the tax laws restrict the sources of profit against which the entity can utilise a deferred tax asset. This assessment is made only in combination with other deferred tax assets of the same type;
- the taxable profit against which an entity assesses a deferred tax asset for recognition is the amount before any reversal of deductible temporary differences; and
- an action that results only in the reversal of existing deductible temporary difference is not a tax planning opportunity. To qualify as tax planning opportunity, the action needs to create or increase taxable profit.

IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets*Revaluation method – proportionate restatement of accumulated depreciation*

The proposal clarifies the treatment of carrying amount and accumulated depreciation when an asset is measured using the revaluation model in IAS 16 and IAS 38 as follows:

- The accumulated depreciation is not necessarily restated proportionately with the change in gross carrying amount. It is the difference between the gross and the net carrying amounts. The gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the net carrying amount.
- The other alternative is that the accumulated depreciation is eliminated against the gross carrying amount of the asset and the net amount is restated to the revalued amount of the asset.

IAS 24 Related Party Disclosures*Key management personnel*

The proposal extends the definition of related party to include management entities appointed to perform key management roles.

IAS 36 Impairment of Assets*Harmonisation of disclosures for value in use and fair value less costs of disposal*

The proposal clarifies that the disclosure requirements in IAS 36 are applicable to value in use are also applicable to fair value less costs of disposal when there has been a material impairment loss/ reversal in the period.

Exhibit 12.2: Annual improvements project 2010-2012 cycle

Annual Improvements Project: 2011-2013 Cycle

The IASB published Exposure Draft ED/2012/2 *Annual Improvements to IFRSs (2011-2013 Cycle)* on 20 November 2012. The comment period on the proposals ended on 18 February 2013. At the time of writing, finalised amendments are expected in the fourth quarter of 2013.

A summary of the key amendments is set out in the table below. The proposed effective dates are for annual periods beginning on or after 1 January 2014.

IFRS 1 First-time Adoption of International Financial Reporting Standards*Meaning of effective IFRSs*

The proposal clarifies that an entity, in its first IFRS financial statements, has the choice between applying an existing and currently effective IFRS and applying early a new or revised IFRS that is not yet mandatorily effective, provided that the new or revised IFRS permits early application. An entity is required to apply the same version of the IFRS throughout the periods covered by those first IFRS financial statements.

IFRS 3 Business Combinations*Scope of exception for joint ventures*

The proposal amends IFRS 3 to exclude from its scope the accounting for the formation of all types of joint arrangements as defined in *IFRS 11 Joint Arrangements*, including those involving the contribution of a business to a joint arrangement, and clarifies that the scope exclusion in paragraph 2(a) of IFRS 3 only addresses the accounting in the financial statements of the joint venture or the joint operation itself, and not the accounting by the parties to the joint arrangement for their interests in the joint arrangement.

IFRS 13 Fair Value Measurement*Scope of paragraph 52 (portfolio exception)*

The proposal clarifies that the portfolio exception in paragraph 52 of IFRS 13 applies to all contracts accounted for within the scope of *IAS 39 Financial Instruments: Recognition and Measurement* or *IFRS 9 Financial Instruments*, even if they do not meet the definition of financial assets or financial liabilities as defined in *IAS 32 Financial Instruments: Presentation*, such as certain contracts to buy or sell non-financial items that can be settled net in cash or another financial instrument.

IAS 40 Investment Property*Clarifying the interrelationship of IFRS 3 and IAS 40 when classifying property as investment property or owner occupied property*

The proposal clarifies that IFRS 3 and IAS 40 are not mutually exclusive. Determining whether a specific transaction meets the definition of a business combination as defined in IFRS 3 requires judgement based on the guidance in IFRS 3. Determining whether or not property is owner-occupied property or investment property requires application of guidance in IAS 40. This guidance is not meant to be used to determine whether a property acquisition is a business acquisition or an asset acquisition.

Exhibit 12.3: Annual improvements project 2011-2013 cycle

Future developments and focus areas

The issues expected to be included in the next 2012-2014 Annual Improvement cycle include:

- *IFRS 3 Business Combinations*: Mandatory purchase of non-controlling interests in business combinations; and
- *IAS 34 Interim Financial Reporting*: Disclosure of information “elsewhere in the interim financial report”

At the time of writing, an exposure draft from this cycle is expected to be in Q3 2013.

Conclusion

It may appear, at first glance, that the amendments summarised above are relatively minor given that the intention of the annual improvements project is to clarify guidance and wording, or to correct relatively minor unintended consequences, conflicts or oversights. However, some of these amendments can have a major impact if an entity had interpreted a requirement differently from those clarified by the amendments. For example, an entity affected by amendments to *IAS 12 Income Taxes* – Tax effect of distribution to holders of equity instruments, may have recorded tax effects on distributions in equity instead of profit or loss prior to the amendments. This can have material effects on the entity's results, earnings per share etc when the amendments are adopted. Thus, an entity should evaluate the implications of these changes carefully.

Part 2 – Implementation issues and practical considerations relating to the new revenue IFRS

Background

The currently applicable standards for revenue accounting, *IAS 11 Construction Contracts* and *IAS 18 Revenue*, were issued in 1993. Since then, a number of amendments have been made to these standards as a consequence of other new or amended IFRSs, and a number of revenue-related interpretations were issued, for example *IFRIC 13 Customer Loyalty Programmes*; *IFRIC 15 Agreements for the Construction of Real Estate* and *IFRIC 18 Transfers of Assets from Customers*. However, these amendments and interpretations do not necessarily change the principles in *IAS 11* and *IAS 18*. Therefore, essentially, we have been relying on the same principles for revenue accounting for approximately 20 years. In fact, due to the lack of clear guidance in these standards, various industries have developed their own practices for revenue accounting based on analogy to other accounting frameworks like US Generally Accepted Accounting Principles.

Evolution of revenue standards in IFRS

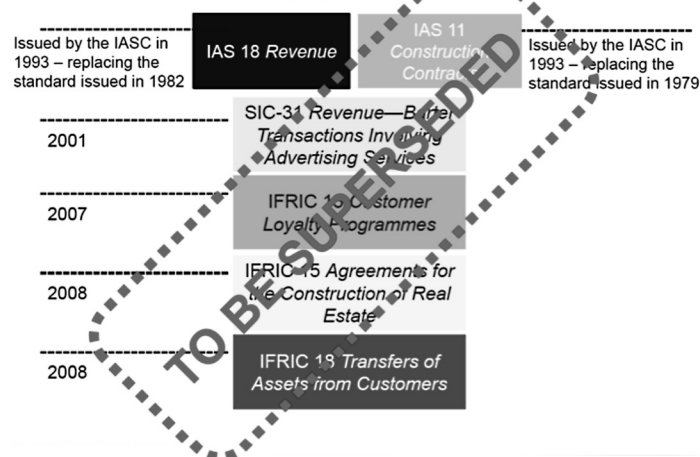


Exhibit 12.4: Evolution of revenue standards in IFRS

At the time of writing, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board are in the final stages of issuing new revenue accounting standards which are largely converged. The new IFRS on revenue accounting introduces new principles surrounding recognition and measurement of revenues and the related disclosures requirements. Although some of these new principles and requirements are consistent with current practices, there are others that may pose challenges. In addition, as the new IFRS is meant to be relevant to a wide range of industries, the impact is also expected to be quite pervasive.

The final new IFRS is expected to be issued by the third quarter of 2013 with an expected effective date of 1 January 2017. This leaves limited time for financial statements preparers to evaluate the impact of the new requirements. This part summarises the key requirements and outlines the potential implementation issues and practical considerations related to the adoption of the new IFRS.



Exhibit 12.5: Timeline for the revenue project

Note that this chapter has been written based on the IASB's tentative decisions on the new IFRS at the time of writing. It is possible that the requirements in the final IFRS may be different. In addition, this chapter may not provide a complete list of implementation issues and practical considerations.

Key requirements that may change from current practice

Core principle:

Recognise revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services

Steps to apply the core principle:

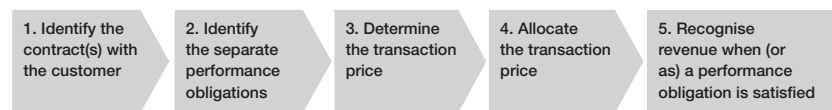


Exhibit 12.6: Understanding the new revenue standard

Although some entities may find that the impact of the new IFRS is small, for others the impact may be very significant. The following outline some examples of how this may happen.

It is possible that a single contract will include both elements within the scope of the new IFRS and elements that are outside its scope (e.g. lease contracts). It will be necessary to separate these elements so as to account for each of them under the applicable guidance. For example, an oil drilling contract may include the provision of drilling equipment (which may qualify as a lease arrangement) and the use of drilling service personnel (which may be scoped into the new IFRS). In some instances, an entity may have to exercise judgment in identifying the different elements. For contracts that contain a lease element, the IASB has recently issued new proposals for lease accounting, and thus, the potential changes to lease accounting will also need to be considered.

The new IFRS has very specific requirements on contract modifications that deal with accounting for changes in price, changes in elements of a contract or both. An entity within industries where contract modifications are common e.g. construction, shipbuilding, telecommunication industries, will need to ensure proper reconfiguration of current processes to deal with the different accounting requirements for each type of modification.

An entity with multiple-element contracts may find that the elements currently unbundled do not correspond to the concept of ‘distinct goods and services’ under the new IFRS. In some instances, an entity may have to exercise judgment in identifying the different elements (known as ‘performance obligations’ in the new IFRS). This will affect, and may delay, the timing of revenue recognition. This is likely to be an area where many entities across multiple industries will be affected. In some instances, under the new requirements, a warranty obligation may be treated as a separate revenue element within a contract. This will have impact particularly for an entity within the consumer business and manufacturing industries, especially when the entity provides an option to customers to purchase warranties separately.

An entity that engages in construction sales, real estate sales or other long-term service contracts will have to pay particular attention to the concept of ‘continuous transfer of control’ in the new IFRS. A few specific criteria need to be met under this concept, before an entity can recognise revenue on a percentage of completion basis. This new concept differs from the current ‘activity-based’ stage of completion model. If the criteria are not met, an entity currently applying a percentage of completion model may be required to recognise revenue at a later point of delivery to the customer, which could possibly be upon completion of construction or service. In some instances, an entity may have to exercise judgment in determining whether the criteria are met. Particular focus will be needed where an entity has commenced work, but the customer has neither physical possession of, nor legal title to, any work in progress.

Impact on key performance indicators

After profits, revenue is perhaps the second most visible number in the financial statements. Early stakeholder education is necessary to explain any potential changes to revenue amounts arising from the new IFRS, so that there will not be undue surprises when the new IFRS is adopted. This may be done as early as possible, beginning with the disclosures required by *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors* (as described below), which give users a heads-up on potential changes when the new IFRS is adopted.

As the new IFRS may result in changes in timing of revenue recognition and presentation of results, certain key performance indicators related to revenue may need to be reconsidered and/or renegotiated. Examples include key metrics used in commission agreements with sales personnel, earn-out clauses in business acquisitions and certain revenue related financial criteria for initial public offerings etc.

Possible impact on income taxes

An entity may also need to consider if there are any income tax implications from the new requirements. In previous years, the Inland Revenue Authority of Singapore has issued helpful tax circulars in response to the issuance of *IAS 39 Financial Instruments: Recognition and Measurement* and *IAS 21 The Effects of Changes in Foreign Exchange Rates*.

Retrospective application

The new IFRS may require an entity to apply it retrospectively with several optional practical expedients, or use an alternative transition method which includes requiring adjustments to opening retained earnings on the effective date for the cumulative impact of initially applying the new IFRS. Both methods may require considerable work in obtaining the necessary information for adjustments or restatements. This work should begin as early as possible.

Extensive disclosure requirements

The disclosure requirements of the new IFRS are expected to be quite extensive compared to current requirements. New requirements could include information on performance obligations (e.g. types of goods and services, significant payment terms, typical timing of satisfaction of the performance obligations, warranty or refund obligations, unfulfilled performance obligations as at period end etc.), information on contract assets and liabilities, and information on manner of allocating transaction price to different performance obligations.

Some degree of judgment is also needed for certain disclosures. For example, an entity may need to disclose a disaggregation of revenue, and the nature and extent of disaggregation should be consistent with segment disclosures and other disclosures presented outside the financial statements e.g. earnings releases, annual reports etc.

Thus, even if an entity believes that its current revenue recognition policy is consistent with the new IFRS, the disclosure requirements alone may require considerable preparation. An entity with multiple revenue streams and/or with decentralised operations needs to ensure it has the necessary information systems to facilitate data collection for the purposes of the new disclosure requirements.

Additional IAS 8 disclosures – impact of new IFRS in future periods

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors requires disclosure of an impending change in accounting policy upon issuance of a new IFRS, including known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application. An entity will be required to disclose this information as early as 2013. For example, if the new IFRS is issued in 2013, a 31 December year-end entity will have to include the relevant IAS 8 disclosures in its 31 December 2013 financial statements.

Conclusion

The new IFRS introduces both accounting challenges e.g. exercise of judgment, data collation for disclosures and operational challenges e.g. review of key performance indicators, income tax exposures.

In respect of accounting, it may be useful for an entity to engage professional advisors early to analyse the full accounting impact. An entity may also engage other entities within the same industry to share views and get consensus on certain judgmental areas and engage its auditors early to get concurrence on accounting judgments made. In addition, an entity may need to invest time to review the terms of its existing and new contracts to evaluate for any unintended accounting consequences.

From an operational aspect, any modifications to contracts to prevent unintended accounting consequences may have follow-on legal, tax or other effects. An entity should ensure that its legal, tax and other professionals also participate in the contract review and modification process. Furthermore, an entity should also evaluate how the proposals would affect its accounting information system.

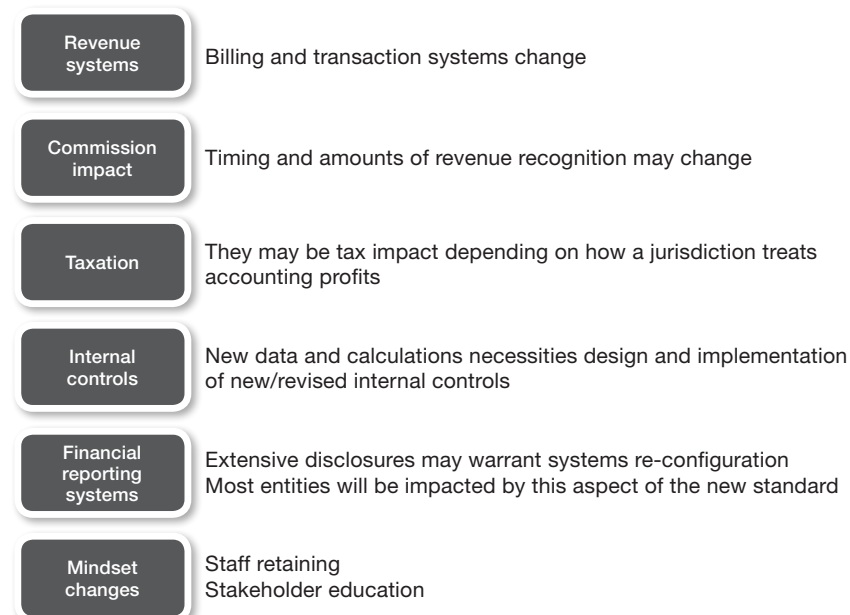


Exhibit 12.7: Operational considerations

Perhaps most importantly, stakeholders (e.g. capital providers, regulators, employees etc.) will need to be informed and educated early on the potential changes. Revenue is a very visible item in financial statements and revenue accounting principles have not changed significantly for approximately 20 years. Early communication is essential to explaining the impact of any change.

Entities should evaluate how the proposals would affect the structuring of customer contracts, performance metrics used, debt covenants, accounting policies, and systems.

References and further reading

Deloitte Touche Tohmatsu Limited (DTTL) maintains a page on www.iasplus.com/en/projects that is dedicated to existing accounting projects undertaken by the IASB. [URL](http://www.iasplus.com/en/projects)

It includes links to summaries of each annual improvements project cycle. Within each annual improvements cycle page, users can find summaries of the improvements (issued or proposed) and discussions on topics related to these improvements. It also includes a summary of the status of the revenue accounting project as well as links to related industry-specific publications on revenue accounting issued by DTTL.

Access to the site is free of charge, and users can register for e-mail alerts for selected topics.

About the Editors and Authors

Editors



Associate Professor of Accounting (Practice) **Them Suwardy** FCPA (Aust.) is the Master of Professional Accounting programme director at SMU School of Accountancy. He has received numerous teaching awards both at SMU and internationally. For his contribution to education, he was awarded Singapore's Public Administration Medal (Bronze) in 2011. In addition to his academic work, he is a regular contributor to professional and regulatory bodies, industry and media. He is currently the Singapore Divisional President of CPA Australia and has previously served as Vice-President of the International Association of Accounting Educators and Researchers (IAAER) and Governor of the Institute of Internal Auditors Singapore. His research interests include financial reporting and disclosures, corporate governance and accounting education.



Dr **Wang Jiwei** is Associate Professor of Accounting (Practice) at SMU School of Accountancy. He has over 10 years' academia and industry experience in corporate reporting, financial analysis and equity valuation. Dr Wang has been doing applied research on international accounting standards (IFRS, Chinese GAAP and US GAAP) and corporate governance. He published research papers in prestigious international journals such as China Economic Review, Journal of Accounting and Public Policy and International Journal of Accounting. He served on the editorial boards to the International Journal of Business, International Journal of Accounting and Singapore Accountant. His research has been profiled in the Financial Times and The Straits Times.

Contributing Authors

Malgosia Aitchison, Director, Accounting Advisory Services, KPMG Services Pte Ltd

Shariq Barmaky, Partner, Assurance & Advisory, Deloitte Singapore

Timothy Braun, Senior Manager, Foo Kon Tan Grant Thornton LLP

Chen Voon Hoe, Partner, PwC Singapore

Reinhard Klemmer, Partner, Professional Practice, KPMG Singapore

Lim Yuan Sing, Associate Director, Transaction Advisory Services, Ernst & Young Solutions LLP

Lin Weiting, Analyst, Accounting and Corporate Regulatory Authority

Gary Pan, Associate Professor (Education), SMU School of Accountancy

Senthilnathan Sampath, Associate Director, PwC Singapore

Seow Poh-Sun, Associate Professor (Education), SMU School of Accountancy

Them Suwardy, Associate Professor (Practice), SMU School of Accountancy

Andre Toh, Partner, Transaction Advisory Services, Ernst & Young Solutions LLP

Wang Jiwei, Associate Professor (Practice), SMU School of Accountancy

Melvin Yong, General Manager – Singapore, CPA Australia

Interviewees

Sanjeev Agrawal, Chief Financial Officer, (Singapore and Southeast Asia), Standard Chartered Bank

Chng Lay Chew, Chief Financial Officer, Singapore Exchange Ltd

David Gerald, President & Chief Executive Officer, Securities Investors Association of Singapore (SIAS)

Lee Suet Fern, Senior Director, Stamford Law Corporation

Chaly Mah, Chief Executive Officer, Deloitte Asia Pacific

Alex Malley, Chief Executive, CPA Australia

Kenneth Yap, Chief Executive, Accounting and Corporate Regulatory Authority

SMU School of Accountancy

60 Stamford Road
Singapore 178900

P: +65 6828 0632

E: accountancy@smu.edu.sg

CPA Australia

1 Raffles Place
#31-01 One Raffles Place
Singapore 048616

P: +65 6671 6500

E: sg@cpaaustralia.com.au

W: cpaaustralia.com.au



Download a QR code
reader on your smartphone
and scan for a soft copy of
this book.

ISBN 978-981-07-6664-1



9 789810 766641